In the Eyes of the Withholder: The PAYE and its Discontents in Ethiopia

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Let me tell you how it will be
There's one for you, nineteen for me
Cos I'm the taxman, yeah, I'm the taxman

Should five per cent appear too small
Be thankful I don't take it all
Cos I'm the taxman, yeah I'm the taxman

The Beatles, Song, Taxman

1. Introduction

Withholding taxes come in all sorts of varieties and emerge in all kinds of places. In some respects, they are as ubiquitous as taxes themselves. They pop up when we cross borders carrying goods (unless we are in the dangerous and precarious game of smuggling goods). They emerge when we receive payments for goods and services. They appear on many payment receipts and invoices that we do not even normally suspect carry withholding taxes. The most prominent among these withholding taxes is the value-added tax (VAT). Indeed, most of the taxes that go under the generic name of "indirect taxes" are in substance withholding taxes in so long as those who collect these taxes include the taxes in the prices of the goods and services they supply to consumers. In the modern times, there is really no place too sacred not to have been haunted and insinuated by withholding taxation.

While withholding has such a ubiquitous presence in daily transactions, the withholding taxation most of us [by "us" I am referring to employees and

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employers) remember is the withholding of income taxation from wages and salaries. Withholding of income tax on wages and salaries of employees is said to have "done more to increase the tax collecting power of central governments than any other one tax measure of any time in history."[1] It has spawned many a progeny of its own in many areas of taxation, but it remains the most conspicuous and most reliable form of tax collection throughout the world.

The withholding tax on employee income (sometimes referred to us the Pay-As-You-Earn (PAYE), or Pay-As-You-Go (PAYG) in some tax systems) is also one of the most productive sources of tax revenues for many governments and as result the most popular among governments. In the United States, a 2009 data showed that employers collected about 56 percent of the gross revenue collected by the IRS (1.28 trillion out of the total 2.3 trillion).[2] The PAYE constitutes more than 75% of the total tax revenue in developed countries and more than 90% in some developing countries.[3] In many tax systems, withholding income tax on wages and salaries is "the mainstay of effective personal income taxation."[4]

Lured by the productivity and simplicity of withholding taxes, many income tax systems have instituted withholding taxation schemes for multiple sources of income besides that of income from employment.[5] Many income tax systems require withholding taxation at varying rates for sources of income as diverse as "dividends," "interest," "royalties" and other sundry sources of income.[6] The number of sources of income subject to withholding taxation varies from one

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[1] MacGregor (1956) quoted in John Tiley, Revenue Law (5th edition, 2005), Hart Publishing, p. 226

[2] Daniel J. Pilla, "Ten Principles of Federal Tax Policy," Legislative Principles Series, No. 9, the Heartland Institute, p. 8 available on http://heartland.org/sites/all/modules/customs/heartland_migration/files/pdfs accessed on August 05, 2012

[3] See Victor Thuronyi, Comparative Tax Law (2003), Kluwer Law International, p. 254

[4] Richard M. Bird, Tax Policy and Economic Development (1992), The John Hopkins University Press, p. 103

[5] See Victor Thuronyi, supra note 3, p. 246

[6] See Perla Gyongyi Vegh (ed.), OECD Model Tax Convention on Income and on Capital and Key Tax Features of Member Countries(2005), IBFD Tax Travel Companion, pp. 389-390, 401, 406, 415, 426, 431-432, 447, 456, 460-461

country to another, although there are now substantial similarities in the patterns of withholding tax systems throughout the world.

Withholding taxes in general, and the PAYE in particular, are generally popular with tax administrations throughout the world because they are extremely easy to administer, very productive and less susceptible to controversies with taxpayers. On the whole, withholding tax schemes are less susceptible to controversies than their self-assessment counterparts because they obviate the need for direct contact (and thus confrontation) between the taxpayers and tax administration. The withholding tax schemes have also been so thoroughly formalized through the years reducing the grounds for controversy by a considerable margin.

The trouble with withholding taxes is that they can be so seductive to tax administrations as to proliferate in various places and guises. Sometimes, the multiple withholding schemes are not well-coordinated and harmonized creating conflicts of judgment over which withholding rate applies in a specific situation. The withholding tax rules may also be ill-designed, defective or so riddled with ambiguities and loopholes that they can become a source of controversies as any other method of collection or even worse. The sources of controversies can be many, but the common controversies surrounding withholding taxation arise from multiplicity of withholding tax rates and the discriminatory or privileged treatment of some sources of income over other sources of income.

The Ethiopian withholding tax system (if such a thing can be said to exist) has entertained more than its fair share of controversies. In view of the frequency and regularity with which these controversies arise in a number of institutions, however, it may come as a surprise that few cases directly addressing the issue of withholding taxation on employment income have ever made it to courts. Those who are accustomed to view legal controversies from the narrow chink of court cases might thus be misled to conclude that all is quiet on withholding taxation front. Nothing can be farther from the truth. Controversies on withholding taxation are as common as any tax issues in Ethiopia.

The reason why legal controversies regarding withholding taxation in the context of employment rarely make it to courts is due to the peculiarity of tax dispute settlement schemes in Ethiopia. The tax dispute settlement schemes in

Ethiopian tax laws are designed to entertain only tax cases that have their origin in tax assessments by the tax authorities. Since withholding taxation schemes by definition obviate the need for tax assessment by the tax authorities, those taxpayers whose income is subject to withholding taxation are rarely able to directly challenge the assessments by the tax authorities unless the withholding taxation is itself part of tax assessment at some later time.[7]

The aim of this article is to investigate the nature of these controversies, analyze the relevant laws, highlight some of the major legal and practical problems in this regard, and propose some solutions, if possible, to overcome, or at least appreciate the depth and breadth of the problems of withholding taxation in Ethiopia. Since we know that legal controversies surrounding withholding taxation in the context of employment are abundant in Ethiopian tax practice, we must look beyond court cases to understand the nature of these controversies.

In analyzing the laws, the article goes beyond the usual suspects of what are known as "laws" and examines the various directives, circulars, memos and letters in place to highlight and diagnose the problems of withholding taxation in Ethiopia with particular reference to those subject to withholding taxation in the context of employment. The legal status of these other "subsidiary" rules has been considered moot in the Ethiopian tax system, but there is little question that these "subsidiary" rules and laws are binding sources of tax administration behavior and, aside from the subtleties of what is to be considered "law" in the proper or formal sense of the term, these subsidiary rules have controlled the behavior of all the parties to the dispute: the tax authorities, withholding agents and taxpayers (e.g., employees).

The article also surveys the practice of withholding taxation in selected higher education institutions of Ethiopia to highlight the discrepant practices of withholding taxation in even among similar institutions – in this case institutions of higher education. The selected higher education institutions are

[7] The existing tax dispute settlement schemes in Ethiopia could be creatively deployed to accommodate withholding taxation (by interpreting withholding as a form of tax assessment), but the fact that in practice, those whose income is subject to withholding have rarely done so only confirms that those creative ways of interpreting the laws never materialized in Ethiopia.

not, of course, representative of the practice of withholding taxation throughout the country, but in a way these institutions are a microcosm of the subjective and haphazard ways withholding decisions are made in various institutions of Ethiopia.[8] One discrepancy in withholding taxation is one too many (and not just an anomaly) and is as much a violation of the law (if the law can be known with any certainty) as thousands of discrepancies.[9] The point of the article is not to make some statistically fool-proof argument about discrepant practices in withholding taxation but to draw attention to the legal and institutional gaps that have made such practices possible on the ground.

The article is organized as follows. First, the article will review the various forms and types of withholding taxation in general, including the famous PAYE system in the context of employment. Secondly, the article will analyze one of the fundamental concepts in the application of withholding taxation – that of employment, and will review the various laws of Ethiopian tax system for distinguishing the concept of "employment" from that of related services, such as "self-employment" or "independent contract services."[10] One of the payments that frequently gives rise to controversies in the context of higher education institutions is the payment for the writing of modules and other academic materials by full-time and part-time lecturers in the universities and colleges. The article will review the shifting opinions of withholding agents and the tax authorities on the characterization of these kinds of payments to draw attention to the uncertainties surrounding certain payments for performance of services in the context of employment.

The article will then present the results of preliminary surveys done on three higher education institutions of Ethiopia and will compare the practices with the laws in this regard. The surveys are the result of interviews conducted with decision-makers (finance officers) of the respective higher education institutions, and the results of the surveys have been supplemented by the

[8] See Muuz Abraha, Income Tax Withholding in Higher Education Institution in Mekelle City, Mekelle College of Law and Governance Studies, Graduate Program in Taxation and Investment, 2011, unpublished

[9] Courts make decisions on the basis of the facts of each case and ask questions of whether the facts show violation of the rules of withholding, not whether many other cases of violation exist.

[10] The expressions "independent contract services" and "self-employment," "independent contractor" or simply "contractor" are used interchangeably in this article.

"Letters" on the basis of which the finance officers claim to be making withholding decisions. After reviewing the controversies surrounding withholding taxation both from the vantage point of the laws and the practice, the article will make some "modest" as well as "not-so-modest" proposals to overcome some of the recurrent problems faced in connection with withholding taxation in Ethiopia. The article will end with some concluding remarks.

2. Why Withholding Matters under the Schedular Income Tax System of Ethiopia

The controversies over the proper withholding income tax rate and schedule arise in the Ethiopian context because the tax rates and burdens vary considerably under the different schedules of Ethiopian income tax system. To start from the obvious, the withholding tax rates in cases where an employer decides that it is income from employment are progressive, whose rates rise as the income received in itself or aggregated with other income from employment rises. The withholding tax rates in cases where an employer decides that the income is income from business (by a contractor) are flat: 2% if the contractor is able to furnish a TIN or 30% if the contractor is unable to do so. These are the two frequently warring withholding rates, but as shall be seen below, some employers have characterized certain forms of income in the context of employment as "royalties," which brings to the table another flat tax rate: 5%, which is final.

It is easy to see what is at stake as far as tax burdens are concerned. Some within the tax authorities may argue that the 2% tax is an advance tax (which it is) and therefore by no means indicates the actual tax burden borne by independent contractors at the end of the tax period. Because of structural and administrative weaknesses of the Ethiopian tax system, however, the 2% withholding operates pretty much as a final tax for most of those who provide independent contract services without possessing a professional or occupational license. Even if the independent contractors go on to settle the final tax liability at the end of the tax period, the tax burden is still lower than what it would have been had the income been characterized as income from employment. Those who perform services under independent contractual relationships are therefore allowed to split their total income into one of employment and of independent

contract, in the process considerably reducing their total tax liability. Though some offer palliative arguments like the 2% tax is an advance tax to counter the complaints of employees, most employees understand that real tax burden differences underlie the whole argument of whether to withhold tax under Schedule "A" or Schedule "C" or Schedule "D."[11]

The real differences in tax burdens can be seen in one hypothetical case involving an employee (A). It will be seen in the analyses that follow that certain payments may be treated equally as "income from employment" (Scenario One) or "income from independent contract of services" (Scenario Two) or "income from royalties" (Scenario Three) just to name the three possible characterizations in this regard. Payments for writing of distance modules may be (and have been) characterized as "income from employment" or "income from independent contract of services" or "royalties." If A, whose regular monthly salary is 5000 ETB, has received 10, 000 ETB for writing distance modules, her tax deductions from total income would be as shown in the following table.

Table 1.1: Withholding Taxation under the Different Schedules of Ethiopian Income Tax (A, C and D)

Scenario One	Scenario Two	Scenario Three
4587.2	1287.2	1587.2

As can be seen from the table above, A's tax deduction would triple in cases where the income from the writing of modules is characterized as income from employment. A's tax deduction is notionally the lowest in Scenario Two under which A's income from writing of modules is characterized as income from

[11] Ethiopian income tax system is a typical schedular income tax system in which income is taxed under separate schedules organized around known sources of income: Schedule A (income from employment); Schedule B (income from rental of buildings); Schedule C (income from businesses as well as professional and/or vocational occupations); Schedule D (income from miscellaneous sources, such as royalties, interest and dividends); in addition there are autonomous income tax regimes for mining, petroleum and agricultural activities; see Taddese Lencho, "Towards Legislative History of Modern Taxes in Ethiopia (1941-2008)," Journal of Ethiopian Law, vol. 25, No. 2, 2012

independent contract services, but since this is not a final tax, it may be higher than Scenario Three, but it will never get anywhere near Scenario One. The least favorable position is Scenario One, under which the income is considered to be one of "income from employment."

In any case, since the differences are so stark, it does not take the subtle knowledge of tax law to fume at the prospect of withholding taxation under Schedule "A". The situation is exacerbated under the Ethiopian income tax system because of the segregation of one form of withholding taxation from the other withholding taxes. An employee whose income is subject to the highest tax rates of Schedule "A" cannot obtain a relief at some point of the tax calendar because her annual income deserves to be treated under lower progressive tax rates. There are no rules that allow employees, who overpay income taxes, to obtain some tax relief by way of tax credits at the end of the tax year.

3. Varieties of Withholding Taxation

3.1. The PAYE

Of all the withholding schemes ever devised by governments, the withholding scheme on employees' payments, known as the "Pay-As-You-Earn' (PAYE)," is probably the most famous.[12] Its popularity is attributable to its enormous ease of administration and equally enormous revenue productivity. The PAYE scheme of withholding enables governments to raise huge amounts of revenue at one of the lowest costs of tax administration in existence.[13] The PAYE scheme raises "a lion's share of the personal income tax" and its yield is said to exceed the revenue of general sales tax or value added tax (VAT) in the industrialized countries.[14] The PAYE scheme assumes an even more revenue importance to the poorly equipped tax administration of developing countries,

[12] Konraad van der Heeden, "The Pay-As-You Earn Tax on Wages," in Victor Thuronyi (ed.), Tax Law Design and Drafting (1998), International Monetary Fund, vol. 2, 1998, p. 564

[13] Id, pp. 564-565; it is clearly cost effective for the tax administration if we disregard the costs of tax compliance by withholding agents.

[14] Ibid

although for reasons it is not appropriate to go into in this article, the VAT and other indirect taxes far outstrip the PAYE in revenue performance.[15]

Employment income is subject to PAYE in almost all countries of the world.[16] In many developing countries, withholding tax by employers is considered final, which relieves both employees and the tax administration from the administrative pain of self-assessment at the end of the tax year.[17] Some developed tax systems, notably the USA, make use of the PAYE but consider the tax withheld as advance payments for the final tax to be settled at end of the tax year when all taxpayers, including employees, are in principle required to file self-assessment tax returns.[18]

3.2. Other Withholding Income Taxes

3.2.1. Withholding Taxes on "Income from Capital"

Withholding taxes are commonly used against other sources of income, although not as extensively as income from employment. Many income tax systems employ withholding taxes on the so-called "income from capital," sometimes also known as "investment income" or "passive income."[19] The individual details of "income from capital" vary from country to country, but the common forms of "income from capital" include dividends, royalties and interest. In schedular income tax structures, these types of income are often treated under separate schedules, and in some of the schedular income tax systems, the withholding taxes are treated as final. In global income tax structures, these types of income form part of the repertoire of individual income, but may become the subject matter of withholding taxation at source.[20]

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[15] In developing countries, the VAT and taxes on international trade (customs tariffs) are more productive of revenue than the PAYE. The PAYE is nevertheless the most productive of personal income taxes in developing countries; see id, p. 565

[16] The exceptions that Thuronyi cites are France, Switzerland and Singapore; see Victor Thuronyi, supra note 3, p. 254; see also, Koenraad van der Heeden, supra note 12, p. 564, foot note 2

[17] See Victor Thuronyi, supra note 3, p. 255

[18] See ibid

[19] See Richard Bird, supra note 4, p. 104; see also Victor Thuronyi, supra note 3, p. 255

[20] Federal Tax Course, 2000, CCH Editorial Staff Publication, CCH Incorporated, Chicago, 1243

Withholding taxes may be designed as final tax liabilities, or as advance payments. When withholding taxes are considered as advance payments, the taxes withheld are often credited against the final tax due on the income of the person. In typical global income tax systems, withholding taxes are used as advance payments, and would be credited at the end of the tax year against the final tax liability of the person. In scheduler income tax structures, particularly of the developing world, many withholding taxes are treated as final taxes. This typically means that the incomes subject to withholding taxation are not added to the other income of the person, and the taxes withheld are not creditable against any other income tax liability of the person.

Ethiopia has used withholding taxation schemes against an assortment of income known as "miscellaneous income" or "other income" since 1978.[21] One of the four schedules of the main income tax system of Ethiopia (Schedule "D") appears to be designed primarily for applying final withholding taxes against certain sources of income. The list of "miscellaneous income" subject to final withholding taxation under Schedule "D" is more extensive than most other income tax systems, but some on the list may qualify as "income from capital." The number of specific types of income subject to final withholding taxation in Ethiopia keeps growing from time to time and at the time of writing includes "royalties," "income from technical services rendered from abroad," "income from games of chance," "dividends" and "interest from deposits." All of the withholding taxes under Schedule "D" are considered final taxes. With the exception of tax on "income from technical services rendered from abroad," which is obviously exclusively intended for non-residents, the withholding taxes in Ethiopia apply to both resident and non-resident taxpayers.

3.2.2. Withholding on Payments for Goods and Services

Withholding taxes can also be applied to transactions or on supply chains. These types of taxes are withheld at designated loci of movements of goods and services in the market, such as on imports and exports, and domestic supplies of goods and services. Customs are commonly used as loci for collection of non-

[21] See Proclamation to Amend the Income Tax, 1978, Proc. No. 155, Negarit Gazeta, 38th year, No. 3 (now repealed)' see also Taddese Lencho, Towards Legislative History of Modern Taxes in Ethiopia, supra note 11, pp.121

final withholding income taxes. The very factor that made customs ideal for collection of various indirect taxes (customs duties, excise duties, VAT and others) has also made them convenient spots for collection of advance income taxes. Sometimes, exports are also be used for collection of income taxes.

Apart from imports and exports, organizations may also be used as withholding agents for income taxation of suppliers of goods and services. Just as organizations have been used to withhold income taxes from their employees or collect VAT from supplies of goods and services, they may also be used as withholding agents from payments to third parties for the provision of various goods and/or services. Unlike withholding employment income taxes, however, these schemes of withholding are often treated in many income tax systems as advance payments, to be settled at the end of the tax year by suppliers of goods and/or services from whose payments the income taxes were withheld.[22] The adoption of these schemes of withholding depends on the degree of tax compliance in the self-assessment income tax regime (which occurs at the end of the tax year) and on how much the government needs advance cash flows to carry on governmental responsibilities. These schemes of withholding are effective in collecting at least some tax from hard-to-tax suppliers of goods and/or services. In that regard, they act effectively as final taxes against hard-to-tax suppliers of goods and/or services.

[22] In Botswana, commissions or brokerage fees paid for the procurement of goods are subject to a non-final withholding tax of 10%; rental payments subject to 5% withholding; see Jude Amos, Botswana, Corporate Taxation, Country Surveys, IBFD, updated up to 7 November 2012, section 1.6.2; in Ghana, interest (8%), supply of goods and services (15%), rent (8%), commission for insurance and sales persons (10%), commission for lotto agents (5%),; Kennedy Munyandi, Ghana, Corporate Taxation, Country Surveys, IBFD, Section 1.6.2, updated up to 31 March 2013; Kenya applies non-final withholding taxes on a number of sources, except dividends for which the tax is final; management, professional and training fees (5%), royalties (5%), interest on government bonds (from 10 to 15%), income received from sale of property or shares (10%), insurance commissions (5% for payments to brokers, 10% for payments to other agents), contractual fees (3%); Frederick Omoni, Kenya, Corporate Taxation, Country Surveys, IBFD, updated up to 4 March 2013; in Sudan, all government payments to taxable persons are subject to withholding(1%), as are imports of goods by taxable persons (2%), payments by local companies to resident contractors and sub-contractors (5%), consultancy fees (10%); Abdelgader A. Osman, Sudan, Corporate Taxation, Country Surveys, IBFD, Amsterdam, update up to 1 February 2013

Ethiopia had these forms of withholding taxes in the early days of Ethiopian modern tax period[23] and has revived these taxes since 2001.[24] Back in the 1950s, Ethiopian income tax laws required withholding of income tax on imports at the rate of 4% and on exports at the rate of 1%.[25] Since 2001, Ethiopia has used imports as places of withholding income taxes and various organizations for withholding of income taxes from payments for supplies of goods and services. The current withholding tax rate is 3% on imports (calculated on the basis of cost, insurance and freight (CIF)) and 2% on both supplies of goods and services, which is calculated on the gross payments for these supplies.[26]

4. Forms of PAYE

The PAYE is the most famous form of withholding taxation throughout the world. The PAYE, as it operates in various tax systems, has assumed three basic forms: simple PAYE, cumulative PAYE, and year-end-adjusted PAYE.[27]

4.1. Simple PAYE

The simple PAYE involves, as its name suggests, a simple process of withholding taxes from monthly wages and salaries, without any adjustments for overpayments or underpayments resulting from the differences in the monthly accounting system from the annual accounting system.[28] The simple PAYE scheme disregards the differences in the tax burdens for the sake of the extraordinary simplicity of withholding taxes from monthly employment income payments, treating the amounts withheld as final. The result is that

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[23] See the Personal and Business Tax, 1949, Legal Notice No. 138, *Negarit Gazeta*, 9th year, No. 4 and Legal Notice No. 164/1952, *Negarit Gazeta*, 11th year, No. 9; see also Taddese Lencho, supra note 11, p. 117

[24] See Income Tax (Amendment) Proclamation, 2001, Proc. No. 227, *Federal Negarit Gazeta*, 7th year, No. 9

[25] See the Personal and Business Tax, 1949, Legal Notice No. 138, *Negarit Gazeta,* 9th year, No. 4; See id, Article 2(ii); the withholding tax rate was raised in 1952 by 1% for both imports and exports; see Legal Notice No. 164/1952, *Negarit Gazeta*, 11th year, No. 9

[26] Income Tax Proclamation, 2002, Proc. No. 286, *Federal Negarit Gazeta*, 8th year, No. 34, see Articles 52 and 53; Income Tax Regulations, 2002, Regulations No. 78, *Federal Negarit Gazeta*, 8th year, No. 37, Article 24

[27] Koenraad van der Heeden, supra note 12, p. 567; see also Richard M. Bird, supra note 4, pp. 100-103

[28] Koenraad van der Heeden, supra note 12, 2, p. 567

employees whose monthly income fluctuates during a year (as a result of, for example, of salary raises) might be made to pay more than what they should pay if adjustments were made at the end of the tax year. The following table shows the income tax liability of an employee, A, with and without final tax year adjustment. An employee whose regular salary was 2000 Birr for half of the year and whose salary is raised to 3000 after six months has annual taxable income of 30, 000. This employee's tax liability under the monthly simple PAYE scheme is higher than her annual tax liability if her annual salary were aggregated and taxed on annual basis. The following table shows the difference if the tax computations are done according to the progressive income tax rates of current income tax system of Ethiopia.[29]

Table 1.2: The Effect of Simple PAYE on Employee Income Tax Liability

Total Income	Tax under a simple PAYE	Tax under the annual scheme	Difference
30,000	4785	4680	105

By denying any adjustment at the end of the tax year, the simple PAYE system is even more unfair upon employees who lose their employment in the course of the year and thereafter remain without gainful employment in the course of the year. The simple PAYE scheme assumes that the income of employees remains steady throughout the year. Thus an employee whose monthly income falls in the top marginal tax rate category is required to pay under the highest marginal tax rates although that employee lost her employment in the course of the year. Since the simple PAYE scheme bars any re-computation at the end of the tax year in light of the changing employment status of the person, its presumptuous tax computation based purely on monthly income results in over-taxation of employees who lose their jobs in the course of the year. In contrast, a trader who finds herself in similar situation (e.g., ceases trade) is assessed on the basis of the taxable income obtained up to the cessation of the trade since the cessation

[29] For the rates, see Income Tax Proclamation No. 286/2002, supra note 26, Articles 11 and 19 (b)

of trade is taken into account in the computation of income tax liability at the end of the tax year.[30]

The effect of a Simple PAYE scheme can be illustrated by an example as simple as the scheme itself. An employee whose monthly income is 4000 ETB and who loses her job after six months will pay more taxes under a Simple PAYE scheme than is under an annual income tax system. Under the current rules of Ethiopian income tax system, an employee would pay 4770 ETB in six months under a Simple PAYE scheme and would have only paid 4230 under an annual income tax system (a difference of 540 ETB). These tax burden differentials arise from the operation of simple PAYE in a progressive tax rate structure of the income tax system, under which the monthly income of the employee is taken as a final index for measuring the employee's income throughout the year.

4.2. Cumulative PAYE

The cumulative PAYE, adopted in countries like Russia and the U.K.,[31] involves a re-computation of the PAYE to ensure that the tax withheld in individual months is equivalent to the tax due in a tax year.[32] After a salary raise, "the PAYE of the next pay period is increased by the month's share of the difference between the income tax on total income prospectively to be earned during the tax year, and the tax already withheld in the tax year".[33] In the cumulative PAYE, any raise, or for that matter, any reduction of employment income immediately triggers an adjustment in the computation of the tax to be withheld in anticipation of the differences that might arise for the rest of the tax year. In a way, the cumulative PAYE is an attempt to reconcile the differences in the monthly accounting process of monthly withholding tax on employment income and the computation of income tax in general using the "tax year" as a basic unit of time.

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[30] In this regard, see Income Tax Proclamation No. 286/2002, supra note 26, Article 47(2)
[31] For the UK, see John Tiley, supra note 1, p. 230
[32] Koenraad van der Heeden, supra note 12, p. 568
[33] Ibid

4.3. Hybrid PAYE

And then there is the so-called hybrid PAYE – a hybrid of both simple PAYE and the cumulative PAYE.[34] During the tax year, the hybrid PAYE proceeds as if there were no need for adjustment at the end of the tax year and treats each monthly income as final (which is what gives the scheme the veneer of the simple PAYE).[35] At the end of the tax year, however, the final withholding is recomputed on the basis of the yearly income information received by an employee – on a cumulative basis, and the tax due at the end of the tax year and the tax already withheld throughout the tax year are compared, and appropriate adjustments are made accordingly.[36] If the difference shows a credit in favor of the taxpayer, the government will refund the taxpayer, and if the difference shows that something more is owed to the government, the taxpayer will be required to pay that difference.[37] In the example given in the table above, an employee will be able to obtain a refund of 540 ETB when an adjustment is made at the end of the tax year. The hybrid PAYE or the year-end-adjusted PAYE is followed in many industrialized countries like Germany and Japan.[38]

5. The PAYE in Ethiopia

5.1. Introduction

The Ethiopian income tax system has used the PAYE as a scheme of tax collection from the income of employees for a long time. Ethiopia has followed the simple PAYE scheme in which tax deducted monthly by employers acts as the final tax liability of employees in respect of their employment income. As far as employees are concerned, the disadvantages of the Simple PAYE are not relieved by any adjustments at the end of the tax year. Employees whose monthly income rises in the course of the year are treated as if their incomes had been steady throughout the year. Employees who lose their jobs in the middle of the year and are unable to find jobs are treated as if their monthly incomes were equal to those employees who have maintained their job throughout the year. In

[34] Ibid
[35] Ibid
[36] Id, p. 569
[37] Ibid
[38] Id, p. 568

short, the monthly accounting system of withholding taxation locks the fate of the tax burdens of employees in the monthly income received regardless of what happens throughout the year.

The system of withholding taxation on income from employment appears to be designed for its simplicity of administration. The system ensures that employees will have no contacts with the tax administration as the administration deals only with the withholding employers. The system is so thoroughly and singularly dependent upon the collection by employers that most employees are not even aware that exceptions are made in some situations in which employee self-assessment is required. The first exception is made for employees of embassies and international organizations enjoying diplomatic immunity.[39] These employees are required to declare and pay the tax due themselves (in other words, they are subject to the regime of self-assessment). The second exception is made for employees who work and obtain income from more than one employment. Two distinct obligations are imposed in the second exception. The employers themselves are required to aggregate the income from multiple employments if they have known that an employee works for other employers as well.[40] In addition, the employees are required to declare their total income (from multiple employments) and pay the difference between the tax due on the total income from employments and the tax withheld by individual employers respectively.[41] The obligation of employees to declare and pay the tax is not contingent upon the employers discharging their obligation to aggregate and deduct the tax upon total income, although in practice, it is the employers who (when they discover) shoulder the burden of aggregating and deducting the tax upon the total income of employees. The rationale for the second exception is that the tax due on the aggregate income of employees is different (and higher) than the tax due on the separate income from individual employment due to the operation of the progressive income tax structure.[42]

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[39] Income Tax Proclamation No. 286/2002, supra note 26, Article 65(4)
[40] Id, Article 65(5)
[41] Id, Article 65(4)
[42] Note, however, that the exception is made in favor of the government's interest to generate more revenue only. When the system results in employees paying more taxes than they should, there are no rules that enable employees to get a refund for excess taxes paid.

5.2. Prerequisites for PAYE Withholding in Ethiopia

The PAYE is a predominant modality of tax collection under Schedule "A" of the Ethiopian income tax system. The application of the PAYE is contingent upon the scope of application of Schedule "A." The task of employers, as withholding agents, is therefore one of ascertaining whether the income payable to employees is chargeable under Schedule "A" of the Ethiopian income tax system. The Ethiopian income tax laws are not explicit in what employers need to do to ascertain whether the income falls under Schedule "A," but a close reading of the relevant provisions of the Income Tax Proclamation shows that employers (as withholding agents) must at the minimum ascertain the existence of two conditions for the application of Schedule "A" rules. These are:

a. The existence of an employment (or employer-employee) relationship;

b. That the payment has arisen from the employment relationship, and not any other relationship.

These two conditions are cumulative. As shall be seen in the greater part of this article, there are many instances in which the existence of an employment relationship is formally established but the payment made by an employer is not said to have arisen from the employment. In Ethiopian context, the most prominent case was **Shell Eth. Ltd. v. Inland Revenue Administration (IRA)**, [43] in which the then Supreme Court of Ethiopia in 1978 E.C. (1986) held that interest paid by an employer on a provident fund held in the name and for the benefit of employees was not income from employment in spite of the existence of a formal employment relationship between employees and the employer (Shell Eth. Ltd.).

The task of employers today in Ethiopia is complicated by the existence of other withholding taxes, which may apply even after employers have ascertained that the income does not fall under Schedule "A." The non-existence of the two conditions above relieves employers in particular only from the obligation to withhold income tax under Schedule "A" of the Ethiopian income tax laws. It does not necessarily relieve employers from withholding under the other

[43] Shell Ethiopia Ltd. v. Inland Revenue Administration (Civ/App/File No. 763/78, 1978 E.C., Supreme Court), in Amharic, unpublished

schedules of Ethiopian income tax system. Employers may still be required to withhold tax if the payment can be characterized instead as "dividend" or "royalty" or if the payment is considered to be a payment for provision of goods or independent contract services. The desire of the [Ethiopian] Government to use every available outlet of cash flows as notional "withholding booths" has complicated the task of employers in this regard.[44] Under current rules of the Ethiopian income tax system, the existence of layered structures of withholding, each involving fairly complicated legal arguments over the characterization of the payment, has meant that employers and other withholding agents must worry about taxes for most of the payments they disburse to others.

While employers have the difficult task of juggling so many issues in deciding the rate of withholding taxation in Ethiopia, it remains to be the case that the most persistent and most difficult issue is one of distinguishing cases of employment from that of independent contract of services. We shall, therefore, address the more vexing question of "employment" vs. "self-employment" before we move on to the less common issues arising in the context of withholding taxation of income from employment.

5.2.1. Distinguishing Employment from Independent Contract of Services

5.2.1.1. Introduction

In Ethiopia, as in many countries of the world, the PAYE scheme uses employers as withholding agents for collection of employment income tax from the income of employees. Since serious tax penalties attach to default in withholding obligations, most employers take their obligations in this regard seriously, sometimes so seriously as to interpret all cases of doubt in favor of "employment."[45] The reason why many employers take what they regard to be a safe bet on "employment" in all instances of doubt is that the amount of tax

[44] In simpler times, once an employer is satisfied that the payments she is making does not arise from employment, she is thereby relieved from the pain of worrying about withholding taxes.

[45] A withholding agent who fails to withhold tax in accordance with the law is personally liable to pay the tax not withheld and in addition, an agent (the manager and the chief accountant or another senior officer who knew or should have known of the failure is liable for a penalty of 1000 ETB for every instance of failure to withhold the proper amount; see Income Tax Proclamation No. 286/ 2002, supra note 26, Article 90(1), (3) and (4)

collected in cases of employment is far higher than the amount withheld in other cases, which will absolve employers (or so they think) from potential charge of having collected less for the government. Employers are more likely to be challenged by the government for not collecting the "appropriate" withholding tax than by the employees for collecting tax under higher withholding tax rates. This state of affairs has made many an employee unhappy in several places.

Most employers (through their finance officers) rely upon their own interpretations of the Income Tax Proclamation, which has definitions (or sort of) for employment and independent contract services (see below).[46] Employees may protest against this interpretation, but their protests usually fall on deaf ears unless a particular employer is somehow persuaded to think otherwise. Employees have virtually no recourse in the income tax laws against potential abuses and misconstructions of withholding rules. Whether by design or by accident, the dispute settlement schemes in the income tax laws of Ethiopia have excluded these kinds of disputes from going to courts.

In a few instances in which withholding agents relent, they may decide to write a letter to the tax authorities seeking clarification on specific issues, and the tax authorities have at times responded to these letters by providing what they deem to be their own interpretation and guidance on how withholding agents should respond to withholding questions. In practice, these communications with withholding agents are heavily decentralized and individualized. Except in a few situations, the tax authorities have refrained from developing common "test factors" for all withholding agents to follow and instead have opted for providing guidance to employers in response to specific questions as these questions arise. The individual approaches the tax authorities have taken have seen the authorities contradicting themselves from time to time resulting in some of the most flagrant cases of inconsistencies in the treatment of identical payments under different withholding tax rates. The gap between what the Income Tax Proclamation prescribes and the practice of income tax withholding in practice is very wide, as shall be seen below, and this is largely because

[46] Many employers are guided by some vague understanding of the provisions of the Income Tax Proclamation; it is uncertain how many of them seriously consult the Income Tax Proclamation before making decisions about withholding of taxes; encounters with a few of the withholding agents makes it extremely doubtful if the withholding agents ever consult the Proclamation before deciding withholding taxation.

neither the tax authorities nor the withholding agents have seriously followed the wordings of the Proclamation in distinguishing cases of "employment" from that of "independent contract of services."

5.2.1.2. Distinguishing Employment from Self-Employment: Analysis of the Income Tax Proclamation

In its definition section, the Income Tax Proclamation offers general definitions for "employee" and "contractor," with the ostensible aim of defining the scope of employment income tax (Schedule "A") vis-à-vis that of business income tax (Schedule "C").[47] In view of the fact that it is the source of income that is important (i.e. "employment" and "independent contract of services") rather than the person upon whom the economic burden of the income tax falls, (i.e., "employee" and "contractor"), it is strange that the Income Tax Proclamation chose to focus upon the definitions of "employee" and "contractor." We must be content with what we find in the Proclamation, however, as we could have been worse off had the Proclamation offered no definition at all. The meaning and scope of employment and its counterpart – independent contract of services – can be inferred easily from the meanings ascribed to "employee" and its counterpart – contractor – in the Income Tax Proclamation.

Article 2(12) of Income Tax Proclamation of 2002 defines an "employee" as:

> " … any individual, other than a contractor, engaged (whether on a permanent or temporary basis) *to perform services under the direction and control of the employer*"(italics added)

And Article 2(12) contrasts a "contractor" from "employee" as:

> "… an individual who is engaged to perform services under an agreement by which the individual [contractor] *retains substantial authority to direct and control the manner in which the services are to be performed*"(italics added)

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[47] Income Tax Proclamation No. 286/2002, supra note 26, see Article 2(12); ostensibly, because nowhere in the whole body of the Income Tax Proclamation is it made apparent why these definitions are proffered; in practice, the Tax Authorities have made repeated references to these provisions for purposes of drawing distinctions between "income from employment" (under Schedule "A") and "income from independent contract of services" (under Schedule "C"); see below for guidance letters written by the Authorities in this regard.

The definition part of the Income Tax Proclamation pins the distinction between "employment" and "independent contract" upon the existence or otherwise of the element of "control and direction" from the side of the "employer" or the "client." [48] In the words of the Proclamation, as quoted above, an employee is one who "*performs services under the direction and control of the employer*," while a contractor is one who "*retains substantial authority to direct and control the manner in which the services [are] to be performed.*" In tagging the meaning of "employment" vis-à-vis that of "independent contract of services" to the existence or otherwise of "direction and control," the Proclamation undoubtedly opted for substantive (as opposed to that of "formal") criteria for distinguishing cases of employment from that of independent contract of services. This is bracing to know, for no one wants an important matter as that of employment vis-à-vis that of independent contract of services to be determined by recourse to the form of relationships. The problem is that the Income Tax Proclamation offers no details about factors constituting "direction and control."

It is not generally expected that the Proclamation would provide details about factors constituting "direction and control." The details of "direction and control" are not provided in the Proclamation because it was perhaps understood that the elements of "direction and control" would be spelt out either in subsidiary tax legislations or in court cases dealing with issues of employment. It might also have been supposed that the elements of "direction and control" had better be left to the discretion of those charged with distinguishing these cases based on the facts and circumstances of each case. Due to the inadequacies or peculiarities of withholding taxation schemes in Ethiopia,

[48] In addition to the definitions cited above, the Income Tax Proclamation makes reference to "employment" – references which may be read as hints as to the scope of the Schedule of the Income tax that applies to employment income – namely, Schedule "A". For example, in Section II of the Income Tax Proclamation of 2002, Article 12 describes "employment income" broadly as "any payments in cash or in kind received from employment," including "income from former or prospective employment." While this provision makes it clear to reach "all payments in cash or in kind" (despite the practical challenges of doing so), it is not at all clear as to how employers can identify "all payments in cash or in kind" unless they simply assume that all payments made by employers to employees is by definition "income from employment."

however, the Proclamation's evident intent to turn the distinction on substantive grounds of "direction and control" has been abandoned in favor of formal or superficial or mechanical standards.

The courts of Ethiopia have not been able to provide any guidance in the context of income tax withholding as a result of the quirks of Ethiopian tax dispute settlement schemes. Although disputes regarding appropriate withholding rates are common, everyday experiences, these kinds of disputes have virtually been kept out of courts due to the narrow strip of dispute settlement schemes in taxation. Tax cases in Ethiopia are normally set in motion after assessment notifications are sent to taxpayers, who are then able to contest the assessment notifications before the tax authorities themselves, the Review Committees, the Tax Appeal Commissions and, finally, on matters of law, before courts. Since withholding disputes do not involve assessment notifications (in the literal sense these expressions are understood in practice), those involved in and most affected by withholding disputes (e.g., employees) have had a difficult time to take their disputes through the regular channels of tax dispute settlement, namely through the Tax Appeal Commission and to courts on appeal.[49]

Determinations of withholding under Schedule "A" or the other schedules of Ethiopian income tax system are thus mostly made in settings away from courts. Most of the disputes are resolved (not necessarily to the satisfaction of the parties involved) by the withholding agents themselves. More specifically, it is mainly the finance employees or managers of companies and other organizations that are decisive in making the calls as they are in charge of payrolls along with which withholding tax decisions are most often associated.

[49] The quirks of the Ethiopian dispute settlement schemes in this regard have been noted in Taddese Lencho, "The Ethiopian Tax System: Excesses and Gaps," Michigan State Journal of International Law, Issue 20, No. 2, 2012, pp. 372-278; The few cases that the courts have entertained in this regard made it to courts after the tax authorities assessed tax against the withholding agents themselves because the authorities felt that the agents "failed to withhold taxes in accordance with the law." The Shell Ethiopia case (see footnote 43 above) made it to courts after the tax authorities took a direct action (assessment) against Shell Ethiopia accusing Shell Ethiopia of "failing to withhold tax on some payments to its employees." If Shell Ethiopia withheld the taxes, but employees thought that was illegal, employees would have no recourse against Shell Ethiopia or would at least have an uphill battle trying to persuade the tax dispute settlement bodies that assessments were made by the tax authorities.

Some employees may attempt to persuade the withholding agents to withhold tax under lower-rated provisions, but the ultimate decision rests with the agents themselves.

A few of the disputes on withholding taxation are "resolved" after "appeals" to the tax authorities are made. These "appeals" take the informal process of seeking written guidance from the authorities on specific questions of withholding taxation. The tax authorities have attempted to regulate the practice of income tax withholding at various times. The tax authorities have issued at least one Directive to determine the types of services for which 2% withholding taxation is to be made. The tax authorities have also provided interpretative guidance on a number of individual and collective cases by responding through private letters to questions of withholding taxation coming from organizations or institutions seeking guidance, and through so-called "circular letters" which are answers to frequently-arising tax questions in the practice of Ethiopian tax administration. We will analyze the relevant directives, circular letters and private letters written in this regard to examine the positions of the tax authorities, and to draw some conclusions as to whether the tax authorities have succeeded in bringing out the key elements for the guidance of withholding agents in Ethiopia.

5.2.1.3. The Income Tax Regulations of 2002 and the Directive of 2003

The Income Tax Proclamation, as we have seen above, does not go into the details of what factors constitute "direction and control." Due to the peculiarities of tax dispute settlement schemes in Ethiopia, the courts have not been able to play their role of interpreting "direction and control" in the context of income taxation. The task of providing details has therefore been in practice left to subsidiary pieces of legislation. After the promulgation of the Income Tax Proclamation in 2002, one income tax regulation was issued by the Council of Ministers and a number of tax directives have been issued by various tax administration bodies, most notably ERCA itself and the Ministry of Finance and Economic Development (MoFED).

The Income Tax Regulations of 2002, which was issued along with the Income Tax Proclamation of 2002, provides many details left out by the Proclamation, particularly in the area of exemptions, deductions and withholding taxes. The

Income Tax Regulations of 2002 does not, however, furnish details on the elements of "direction and control" as might be expected. Nonetheless, the Income Tax Regulations of 2002 is still useful indirectly because it provides detailed rules on the withholding of tax from payments to independent contractors, with whom employees are often confused.

The Income Tax Regulations lists down more than a dozen different categories of services and/or professionals as qualifying for 2% withholding tax under Schedule "C." Some of the services that are subject to 2% withholding include: consultancy services, design services, writing services, lectures, dissemination of information services, advertisements and entertainment programs for television and radio broadcasts, and construction services.[50] The professionals who are listed in the Regulations as subject to 2% withholding when providing "professional services" are lawyers, accountants, auditors, sales persons, arts and sports professionals, brokers, and commission agents.[51] The Regulations does not state that the list of services and professionals subject to withholding taxation is indicative or exhaustive, but it is clear from the nature of these services and the frequent use of the phrase "other similar services" in some of the lists that the listing was not meant to be exhaustive.

While the Income Tax Regulations helps many a withholding agent to make decisions based on the lists of services and the types of professionals set down thereunder, the Regulations is not going to help withholding agents in borderline cases. The Regulations lists "lectures," for example, as one of the services subject to 2% withholding, but we know that "lectures" can be delivered by both employees and independent contractors. How is a withholding agent to decide when a "lecture" is part of employment or independent contractual relationship? In the end, the Income Tax Regulations forces withholding agents to go back to the general element set down in the Income Tax Proclamation: "direction and control;" a withholding agent is not absolved from determining, based on the facts and circumstances of each case, whether "direction and control" exist in a relationship to decide whether to withhold tax under Schedule "A" or Schedule "C."

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[50] Income Tax Regulations No. 78/2002, supra note 26, see Article 53 (2)
[51] Ibid

Shortly after the promulgation of the Income Tax Proclamation and Regulations of 2002, the Ministry of Revenues issued a (draft?) directive on withholding schemes in Yekatit 1995 E.C. (February 2003), which was to come into force from Hamle 1, 1995 E.C (July 2003).[52] The Directive was issued to regulate the withholding of taxes on imports and payments for goods and services. The said Directive repeats most of the lists of services and professionals listed down in the Income Tax Regulations of 2002.[53]

Unlike the Regulations, however, the Directive of 2003 suggests that, at least in one exception, it is possible to be an employee for some kinds of services and an independent contractor for other kinds of services, even if both of these services are provided for one employer. That exception is provided for "lectures." In its relevant paragraph, the Directive states:[54]

> ለዲዛይን ስራዎች፤ ለፅሑፎች (በተለያዩ መፅሔቶች ጋዜጣዎች ለተለያዩ ሚዲያዎች ወይም ደርጅቶች ወዘተ ፅሑፍ በማቅረብ ከሚገኝ ክፍያ)፤ ለትምህርት ገለፃዎች (በሚዲያ፤ በት/ቤቶች እና በተለያዩ መድረኮች ወዘተ ለሚደረግ ትምህርታዊ ገለፃ ከሚከፈል ተቀናሽ የሚደረግ ሆኖ ትምህርት የሚሠጠው ሰው በተከታታይ (በቋሚነት ከሆነ ትምህርታዊ ገለፃ ከመስጠት ከሚያገኘው ክፍያ በደመወዙ ላይ ታክሎ የሰዎች የስራ ግብር እንዲከፍል ይደረጋል)::

Roughly translated, the quoted paragraph reads:

> Payments for design works, writing (for magazines, newspapers, various media or organizations), lectures (through various media, in schools or other platforms, except when the person providing the lecture is engaged continuously or permanently [in which case the payment shall be aggregated with her salary and tax deducted under the personal income tax schedule (A)].

In the case of "lectures," the Directive states that "*where the person providing lectures is engaged continuously or permanently,*" the payments for the lectures shall be aggregated with the monthly salaries of the lecturer and the appropriate

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[52] Some within the Tax Authorities doubt whether this Directive was still in force but since Directives are not published and seldom rescinded publicly, it is impossible to know which Directives are really in force and which are abrogated; in any case, the Directive is cited in this Article to illustrate the position of the Tax Authorities on the vexed question of employment vs. self-employment; see የገቢዎች ሚኒስቴር፣ የቅድመ ታክስ ክፍያ ስርዓትን (Withholding Taxation) ለማስተዳደር የተዘጋጀ ረቂቅ የአፈፃፀም መመርያ፣ ሐምሌ 1 1995 ዓ.ም፣ ያልታተመ

[53] የገቢዎች ሚኒስቴር የአፈፃፀም መመሪያ ፣ supra note 52, see Article 3.4.1.(2)

[54] Id, Article 3.4.1 (2)

tax shall be deducted under Schedule "A" of Ethiopian income tax law.[55] This phrase in italics suggests that if "lectures are provided for a specific, definite period of time," it is alright for withholding agents to withhold 2% from payments for the "lectures," provided, of course, the lecturer is able to furnish the TIN. The *a contrario* reading of the said Directive leads to the conclusion that when employees provide short-term lectures under specific contracts and for specific payments, the income derived therefrom should be subject to 2% withholding if the lecturer has a TIN (or 30% withholding if the trainer does not have one).

The Directive does not directly address the issue of withholding under Schedule "A," but represents a pattern within the Ethiopian tax administration of relegating substance to the form of relationships and deciding withholding taxes on the basis of the form of agreements. Although the said Directive instructs withholding agents to deduct 2% when the payments are for independent contract services, and to aggregate and withhold the appropriate tax under Schedule "A" when the payments are for employment, it does not mention the critical element of the Proclamation, namely that of "direction and control".

Setting aside the elements of "direction and control" from the consideration of withholding opens the process of withholding to tax planning by parties that are able to take advantage of the list and structure the form of their relationship to fit in one of the lists enumerated in the Directive. Withholding agents can have an easy task of withholding the 2% tax by simply characterizing the service contracts as one of those listed in the Directives, even though the substance of the service is one of employment. In contrast, those employees who are not in a bargaining position to structure their contracts to fit in one of the "independent contract services" listed down in the Directive will be forced to have their payments withheld under the employment income tax even though the nature of their relationship is one of independent contract of services.

5.2.1.4. The Letter Rulings/Administrative Interpretations

Neither the Income Tax Regulations of 2002 nor the Withholding Tax Directive of 2003 directly addressed the issues employers (withholding agents) confront

[55] See id, Article 3.4.1.(2)

in complying with the PAYE. In response to the frequently arising questions for guidance from the withholding agents, the tax authorities have resorted to writing "letters" either to the various branches of the tax administration (from which some of these questions come) or directly to the withholding agents themselves. The written communications on this and many other issues of tax administration with the various units of the tax administration are known in practice as "circular letters" or sometimes "circulars" while the written replies to the withholding agents are known as "guidance letters" or the Amharic equivalent for the federal tax administration of Ethiopia. The legal status (never mind the legality) of these "letters" is not yet fully understood. The letters may go under a tame name of "circular letters" or "guidance letters," but in status and effect, they occupy the same position as "directives" in Ethiopia.[56] We will review the relevant circular letters and private letters written by the tax authorities in this regard.

5.2.1.4.1. The Circular Letter of 2004

In the Ethiopian tax administration, circular letters are written in response to frequently asked questions raised by the various branches of the tax administration. The legal departments of ERCA and the Ministry of Finance and Economic Development (MoFED) from time to time receive questions and requests for guidance from the various branch offices of ERCA which, based on their day-to-day experience of administering taxation on the ground, confront some questions requiring the attention of the higher authorities. At times, the legal departments respond to individual questions as they arise, and at other times, they respond to frequently asked questions by issuing "circulars," which are so-called because these circular letters are distributed (circulated) to the various branch offices of the tax administration for purposes of implementation. These "circulars" represent the interpretation of the authorities, but they operate pretty much like directives because of the lack of recourse for taxpayers to challenge the "circulars." It is not clear how much these circular letters are diffused throughout the tax administration, but it is obvious that members of the

[56] It is not clear as to why the tax authorities prefer "Circular Letters" to "Directives" or for that matter in what circumstances they issue one as opposed to the other.

tax administration consult these circulars whenever issues of interpretation arise.

The Ministry of Revenues (the predecessor of ERCA) issued one such circular letter in 2004 with a view to resolving some of the most frequently raised issues in the income tax laws of Ethiopia. Perhaps not surprisingly, the scope of "employment" for purposes of Schedule "A" income tax withholding was one of those frequently arising questions in the Ethiopian tax administration.[57] The 2004 Circular Letter sought to determine cases in which a specific income falls under Schedule "A" (as income from employment) and Schedule "C" (as income from independent contract).[58] Basing itself on the meaning given to terms "employee" and "contractor" in Article 2(12) of the Income Tax Proclamation, the Circular Letter notes that income from employment does not include the income of a person who has rendered a service under a specific and definite contract. In excluding certain service contracts from the scope of Schedule "A," the Circular Letter states in its relevant paragraph:

> ለተቀጣሪ የተሰጠው ትርጉም አንድ የተወሰነን አገልግሎት ለመስጠት በውል የሚቀጠርን ሰው አይጨምርም። በመሆኑም የሌላ መስርያ ቤት ሰራተኞች የሆኑ ሰዎች ራሳቸውን ችለው የተወሰነ አገልግሎት (የምክር አገልግሎት፤ ጥናታዊ ፅሑፍ፤ ወዘተ) በተወሰነ ጊዜ ውስጥ ለመስጠት ከሌላ መስሪያ ቤት ወይም ድርጅት ጋር በሚያደርጉት ውል መሰረት የሚያገኙት ገቢ በመቀጠር የተገኘ ገቢ ነው ሊባል አይችልም።

The rough translation of the Amharic quote reads:

> The meaning given to "employee" does not include a person who undertakes to provide a service under a specific and definite contract. Thus, persons who are employed by other institutions and organizations but who provide specific services (e.g., consultancy services; writing and presentation of research papers, etc.) under specific contracts are not considered to have received income from employment (translation mine).

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[57] The other issues that received some "interpretative treatment" in that circular include the scope of foreign tax credit (Article 7), the meaning of "casual rental of property" (Article 35), the scope of withholding tax on "interest bank deposits" (Article 36), the scope of loss-carry forward for income tax purposes (Article 28), in the case of VAT, the meaning of "used dwellings" (Article 8(2)(a), the extent of exemptions from VAT of institutions hiring persons with disabilities (Article 8(2)(o)); see Ministry of Revenues, Federal Democratic Republic of Ethiopia, Circular Letter issued on 16 Megabit 1996 E.C., in Amharic, unpublished.

[58] See Ministry of Revenues, Federal Democratic Republic of Ethiopia, Circular Letter issued on 16 Megabit, 1996 E.C., in Amharic, unpublished

On the surface, the Circular Letter reads as an interpretation of Article 2(12) of the Income Tax Proclamation. When we read the paragraph closely, however, we find that the Letter insinuates and adds some requirements or elements to the distinction between "employee" and "independent contractor," requirements or elements which are not suggested in the Income Tax Proclamation. Indeed in the process of purportedly interpreting the meaning of Article 2(12), the Circular Letter ends up completely disregarding the elements of "direction and control" as signifiers of "employment," and their absence as signifiers of "independent contract of services."

The Circular Letter does so by replacing the elements of "direction and control" by easy-to-apply (albeit arbitrary) requirements, which, as can be readily inferred from the paragraph of the Circular Letter quoted above, depend essentially on two factors, namely whether:

i) the contract for services is specific and is not of a continuous nature; and
ii) the person who provides services is a part-timer, having full-time employment elsewhere.

In the Income Tax Proclamation, none of these factors are even intimated as attributes of either "employees" or "independent contractors." Be that as it may, it is important to analyze the practical implications of the Circular Letter cited above. A withholding agent who wishes to conform strictly to the literal language of the Circular Letter (regardless of what the Proclamation prescribes) will perform her withholding obligations in the following ways, among others:

i) If a person providing specific service is a full-time employee, the withholding agent will have to simply aggregate the income from specific contract regardless of the nature of the specific contract (it is immaterial whether the contract is for provision of consultancy services or the presentation of research papers or connected with her full-time (day-time) commitment).

ii) If a person providing specific service is a part-timer, the withholding agent will have to simply treat the income from specific service as income from "independent contract" and withhold 2% unless the

contract is one of continuous nature (how continuous is a continuous contract, the Circular does not offer a clue!).

For a withholding agent anxious to get easy-to-apply signposts, the Circular Letter is clearly superior in its simplicity over that of the Income Tax Proclamation, but there are serious questions over whether the Circular Letter is faithful to the "spirit" of the Proclamation. Indeed, there is no doubt at all that the language of the Circular Letter is not faithful to the spirit of the Income Tax Proclamation. The Letter disregards the requirement of "direction and control" for purposes of withholding tax under Schedule "A" or under Schedule "C".

Besides, the criteria enshrined by the Circular Letter may lead to arbitrary results in practice. The "Circular" induces and authorizes withholding agents to rely upon factors that are not necessarily relevant to the nature of employment or independent contract of services. The factor that is taken to be determinative of the appropriate withholding rate under the Circular Letter is whether or not the person providing the service is a full-time employee of the organizations for which she provides the service. This factor is mostly irrelevant to the question of whether the relationship is one of employment or independent contract of services. A person may provide a self-employment service or a specific contractual service although that person is already an employee of the organization for which she provides the specific service. A full-time employee may provide a consultancy service, a research service, a translation service, etc., to an organization in which she is a full-time employee. As long as these services do not form part of her regular contract, these services are self-employment services and are performed pretty much as if she were not already employed by the organization.[59] Setting aside the argument about whether one should obtain a license to perform these services, the prior status of the service provider (whether she is already an employee or brought from outside) is completely irrelevant to the question of whether the service provided is one of

[59] In the UK, a man who was on the regular staff of a newspaper was said to have acted as independent contractor when he made a translation for the newspaper on his spare time; as Judge Denning observed in Stevenson Jordan and Harrison Ltd v Macdonald and Evans, a doctor on the staff of a hospital or a master on the staff of a school may be considered to be independent contractors if they produce a written work under a special contract; cited in Graham Stephenson, Source Book on Torts, (2nd edition,2000), Cavendish Publishing Limited, p. 569

"employment" or "independent contract of services." Nothing in the law prevents full-time employees from performing specific services like translation, research, consultancy and training to the very organizations in which they are employed.

For the Circular Letter, the decisive factor is the prior relationship of the service provider. In its choice of the form of the contract over the substance of the relationship, the Circular Letter shares some common features with the Regulations of 2002 and the Directive 2003. It is important to note, however, the difference between the Circular Letter and the Directive of 2003. The Circular Letter assimilates all kinds of additional and specific services of a full-time employee into that of "employment" regardless of the nature of the specific service provided while the Directive of 2003 at least concedes the possibility of some full-time employees (e.g. university professors) taking up specific contractual projects which are capable of being characterized as "independent contract services" in spite of their full-time employment status (see above). The question is, faced with contradictory signals coming from the tax authorities, how should withholding agents determine the appropriate withholding rates and schedules?

5.2.1.4.2. Guidance Letters Written to Specific Withholding Agents (Private Letter Rulings)

The Circular Letters, as pointed out before, are addressed primarily to the various branches of Ethiopian tax administration and but may end up in the hands of diligent or well-connected withholding agents. Since withholding agents are frequently confronted by the dilemmas of withholding, they have (some of them in any case) have sought written and oral guidance from the various units of the tax administration to either protect themselves from erroneous withholding practices or (in the case of some of them) to find solutions acceptable both to them and the payees from whose income withholding taxes are deducted. As far as one can tell, these practices have developed as a matter of course and the various units of the Ethiopian tax administration (both at the federal and regional level) have resorted to these practices as a matter of administrative courtesy rather than as a matter of

established administrative procedure.[60] We shall examine some of these "private letters" (or "guidance letters," as they are customarily known) addressed to some withholding agents in response to queries from these agents. We confine ourselves to those private letters addressed to higher education institutions, many of which have relayed their queries to the tax authorities.

The following "guidance letter" is written in response to a request for guidance by one public university in 1999 E.C. (2007). [61] In its relevant paragraph, the "guidance letter" instructs:

> ... ከኮሌጁ ጋር በፈፀሙት የቅጥር ውል መሰረት አገልግሎት የሚሰጡትን በተመለከተ እነዚህ ተቀጣሪዎች ከተቀጠሩበት መደበኛ ስራ በተጨማሪ አገልግሎት በማበርከታቸው የሚከፈላቸው የትርፍ ሰዓትና መሰል ክፍያ ከደሞዛቸው ጋር ተደምሮ ግብር ተቀናሽ የሚደረግበት ይሆናል። እንደዚሁም በሌላ አሰሪ ዘንድ ተቀጣሪ የሆኑ እና በኮሌጁም ተቀጥረው አገልግሎት በመስጠት የሚያገኙት ገቢ በአዋጁ አንቀፅ 65 ንዑስ አንቀፅ 5 መሰረት ገቢው በሌላ ቀጣሪ ያልተጣመረ መሆኑን በማረጋገጥ ገቢው ተጣምሮ ግብሩ መወሰን ያለበት ስለሆነ በዚሁ መሰረት ሊፈፀም ይገባል።
>
> በሌላ በኩል በገቢ ግብር አዋጅ ቁጥር 286/96 አንቀፅ 2(12) ድንጋጌ ለተቀጣሪው የተሰጠው ትርጉም አንድ የተወሰነን አገልግሎት ለመስጠት በውል የሚቀጠርን ሰው የማይጨምር መሆኑ ተመልክቷል።
>
> ከዚህ ድንጋጌ አኳያ የሌላ መስሪያ ቤት ሠራተኞች ሆነው የምክር፤ ጥናታዊ ፅሑፍ የማቅረብ ወዘተ... አገልግሎት ለተወሰነ ጊዜ ለመስጠት ከሌላ መስሪያ ቤት ወይም ድርጅት ጋር በሚያደርጉት ውል መሰረት የሚያገኙት ገቢ በመቀጠር የተገኘ ገቢ ተደርጎ ሊቆጠር አይችልም።
>
> በመቀጠር የተገኘ ገቢ ካልሆነ ደግሞ ከሚያገኙት ደመወዝ ጋር ተደምሮ በሠንጠርዥ ሀ መሰረት ግብር እንዲከፈል ማድረግ አይቻልም። በአንጻሩ ግን በዚህ ዓይነት የተገኘ ገቢ በአዋጁ አንቀፅ 2 ንዑስ አንቀፅ 6 ለንግድ ሥራ በተሰጠው ትርጉም የሚሸፈን በመሆኑ በዚህ አዋጅ አንቀፅ 19 ንዑስ አንቀፅ 2 ድንጋጌ በሠንጠረዥ ሐ መሰረት ግብር የሚከፈልበት ይሆናል።

Roughly translated, this means:

> With respect to those providing services pursuant to contracts of employment, their payments received as a result of providing of additional services shall be aggregated with their salaries and appropriate tax withheld. In addition, income of employees of other organizations who provide part-time services shall be aggregated

[60] The legal status of these written communications, whatever names they bear, remains unclear although in practice, these written communications or private letters have served as binding legal documents almost in an equal footing with provisions in the tax proclamations; see Taddese Lencho, The Ethiopian Tax System, supra note 49, pp. 365-369

[61] See Federal Inland Revenue Authority, Ministry of Revenue, FDRE, letter written to the PuB2, 25/2/1999 E.C., in Amharic, unpublished

> with their full-time income from these organizations pursuant to Article 65 (5) of 2002 Income Tax Proclamation once the College ascertains that their full-time employer has not already aggregated their income.
>
> … the notion of "employee" as defined in Article 12 (sic) of Income Tax Proclamation No. 286/2002 does not cover persons who provide specific services. According to this sub-article, employees of other organizations who provide consultancy services, research papers, etc. under a definite and specific contract with the College may not be regarded as employees and their income may not be treated as income from employment. …
>
> Income derived in this way is income from business pursuant to Article 2(6) of the Income Tax Proclamation of 2002 and shall be subject to tax under Article 19(2) of the same Proclamation.
>
> The obligations of the withholding agents that make payments for these kinds of services is to withhold 2% from the payments pursuant to Article 53(2) of the Income Tax Proclamation No. 286/2002 and Article 24 of the Income Tax Regulations No. 78/2002.

The Letter, cited above, relies upon three signifiers to distinguish cases of "independent contract of services" from cases of "employment." First, the persons who provide the service must be "employees of other organizations" and second the type of services (which are only given as examples) should be in the nature of "consultancy services," "writing research papers," etc. And thirdly, the contract should be for a definite period of time (or specific service). If the person providing a service is a full-time employee, it appears that all income from the part-time work of that employee with the College is to be aggregated with her full-time salary and tax withheld under Schedule "A," regardless of the nature of the specific work. Like the Circular Letter cited previously, the Letter provides a simple test to the withholding agent: is the person providing the service already a full-time employee of the College? If the answer is yes, the Letter instructs the withholding agent to simply aggregate the income from part-time engagement with the employee's full-time salary and withhold tax under the progressive tax rates of Schedule "A". The Letter assimilates all kinds of specific work by full-time employees of the College into one of employment

regardless of the nature of the specific relationship involved. Even if the part-time work is one of consultancy or writing or translation, the Letter instructs the College to aggregate the income from specific service with the full-time salary of the employee involved and withhold the tax under Schedule "A."

Like the Circular Letter cited above, the "guidance letter" substitutes other elements for the element of "direction and control" and departs completely from the spirit and language of the Income Tax Proclamation. If the provider of a service is an employee of another organization (a part-timer), the said Letter instructs the College to distinguish those services that are in the nature of "employment" and those that are in the nature of specific services, such as consultancy work, research work, etc. If the service is for a definite period of time and if it is one of consultancy work, research, etc., the withholding agent is required to withhold tax under Schedule "C" regardless of whether the nature of the work requires "direction and control" from the part-time employer. Since the types of services are given only as examples, the withholding agent has the discretion to characterize almost all forms of "part-time" work as qualifying for withholding tax under Schedule "C."

Another interesting "private letter" is one addressed to another public college in Addis Ababa.[62] Its relevant paragraph is quoted thus:

> ግንኙነቱ በአሰሪና ሰራተኛ ደንብ ተቀጥሮ የሰራ ያለ ከሆነ እና ከመደበኛው ደመወዝ ውጪ በኮንትራት መልክም ይሁን ያለኮንትራት ተጨማሪ ክፍያ የሚያስከፍል ስራ በተቀጠረበት ኮሌጅ ወይም መ/ቤት እየሰራ ያለ ከሆነ በገቢ ግብር አዋጅ 286/96 አንቀፅ 12 መሰረት ከወር ደመወዝ ጋር ተጣምሮ የስራ ግብር እንዲከፍል ይደረጋል:: የኮሌጁ ተቀጣሪ ሆኖ በሌላ አካባቢ በኮንትራት መልክ ሰርቶ የሚያገኘው ገቢ በዚሁ አዋጅ አንቀፅ 53 መሰረት የኮንትራት አገልግሎት በሰጠበት ኮሌጅ ወይም መ/ቤት ወይም ድርጅት 2% የቅድምያ ግብር ክፍያ እንደሚቀነስበት ይደነግጋል:: ይህ 2% ተቀናሽ የሚደረገው አገልግሎት ሰጪው ሰራተኛ የግብር ከፋይ መለያ ቁጥር ሲኖረው ብቻ ይሆናል:: ከሌለው ግን በዚሁ አዋጅ አንቀፅ 91 መሰረት 30% እንዲቀነስበት ይደረጋል::

Roughly, this translates as:

> Where a person performs specific or continuous services to an employer outside his regular employment duties in accordance with a contract regulated by employer-employee relations, the income derived therefrom should be aggregated with his regular salary in

[62] Letter written to Kotebe Teachers' College, ERCA, Arada Sub City Small Taxpayers Branch Office on 22/08/04, in Amharic, unpublished

> accordance with Article 12(sic) of the Income Tax Proclamation No. 286/2002. An employee of the College who performs specific services outside the college shall be subject to 2% advance withholding in accordance with Article 53 of the Income Tax Proclamation No. 286/2002. The law authorizes 2% withholding where the person has a TIN. Otherwise, 30% shall be withheld from the payment for specific services in accordance with Article 91 of the Income Tax Proclamation.

The above letter mentions Article 2(12) of the Income Tax Proclamation for purposes of distinguishing payments subject to aggregation under Schedule "A" and those subject to withholding under Schedule "C" (2% or 30%) but fails to provide in the end any way of distinguishing employment from independent service contracts on substantive grounds. The only guidance the College could take from the Letter is that ultimately the distinction rests on whether the provider of specific services possessed a TIN or not.[63]

Another example is a more recent one, addressed to a faculty of another public university in Addis Ababa, again no doubt in response to the queries from the University Faculty.[64] The relevant paragraph of the said Letter states:

> ... ፋኩልቲው/ዩኒቨርስቲው/ በትርፍ ጊዜ የተቀጠረው ባለሙያ ሌላ መ/ቤት የተቀጠረበትን ማስረጃ በመጠየቅ የትርፍ ጊዜ ክፍያውን ከደመወዙ ጋር በማጣመር የስራ ግብር ማስከፈል ያለበት መሆኑን፤ በሌላ በኩል ባለሙያው የንግድ ፈቃድ በማውጣት የንግድ ትርፍ ግብር ከፋይ ከሆነ እና ከዩኒቨርስቲው ጋር የስራ ኮንትራት ውል ካለው የግብር ከፋይ መለያ ቁጥር ሲያቀርብ 2% ዊዝሆልዲንግ የሚቀነስበት ሲሆን የግብር ከፋይ መለያ ቁጥር ካላቀረበ 30% የሚቀነስበት መሆኑን እንገልፃለን::

[63] Incidentally, the letter purportedly advises the College on the treatment of payments to Kotebe Teachers' College employees who work elsewhere, but this is of little use to the College because it is not the concern of the College as to how their payments elsewhere should be treated; the letter should have addressed the concerns of the College on cases in which the college makes payments to part-time employees or to full-time employees who provide specific services outside their regular employment duties

[64] Letter written to Addis Ababa University, Natural Science Faculty, Addis Ababa, ERCA, Customers Education and Support, 18 Miazia 2004 E.C., in Amharic, unpublished; it is interesting to note in this case that the Natural Science Faculty of Addis Ababa University was able to obtain a separate guidance letter in response to its queries. It is not inconceivable in this context for various faculties and colleges of Addis Ababa University to receive conflicting guidance letters from various units of the tax authorities.

Roughly translated as, the Letter instructs:

> The Faculty/University/ shall aggregate the income of a person from a part-time work with the latter's regular salary from his full-time employer. Where the person who performs part-time work has a business license and can present a TIN to the University, the University shall deduct 2% from the payment. If a person is unable to present a TIN, the University shall deduct 30% from the payment.

The Letter quoted above shares one common feature with most of the letter rulings issued by the tax authorities over the years. This Letter completely disregards the substantive requirement of the Income Tax Proclamation and seeks to resolve the issue on the basis of the presentation or lack of presentation of specific documents: like the business license and the TIN. What sets it apart from similar letters is the fact that it introduces a new requirement to the whole saga of the distinction between employment and self-employment – namely possession of a business license and even an intimation that the withholding agents should ascertain whether the person providing the service pays income tax under Schedule "C." The requirement of a business license is not mentioned in the Income Tax Proclamation, and the letter does not even pretend to have relied upon any specific provision of the Income Tax Proclamation – other than rationalizing somehow that 2% is an advance payment for business profit tax under Schedule "C."

5.3. The Withholding Taxation on Payments for the Writing of Modules and Other Academic Materials: the Vacillation of the Tax Authorities over the Years

Most disputes regarding withholding taxes revolve around whether a withholding agent should aggregate specific income in the context of employment with the regular income from employment (wages and salaries) (Schedule "A") or treat the specific income as "income from independent contract" and deduct 2% (Schedule "C"). The resolution of these disputes hinges, as we have seen above, on whether the relationship is one of employment or independent contract of services.

The practice of many higher education institutions has revealed that in some situations, the characterization may bifurcate into the other sources of income

chargeable with income tax under the various income tax schedules of the Ethiopian income tax system. The issues for withholding agents can bifurcate not only between "employee" vs. "independent contractor" but also between "income from employment" vs. "income from royalties," or "income from employment" vs. "income from dividends" or "income from employment" vs. "income from technical services rendered abroad." Employers or withholding agents are thus no longer worried only about employment vis-a-vis independent contract of services, but also about a whole raft of issues arising in connection with the miscellaneous sources of income chargeable under Schedule "D" of Ethiopian income tax laws: royalties, income from games of chance, income from technical services rendered abroad, and dividends. Since the tax rates diverge quite considerably, employees and sometimes employers have every incentive to characterize specific income under one of the lower taxed miscellaneous sources.

One of the specific contractual commitments which gives rise to possible conflicts of withholding taxation is payments for the writing of various forms of academic materials, particularly that of the writing of distance modules. The controversies over the appropriate withholding tax rates from the payments for the writing of academic materials took different forms depending on the level of understanding of the disputing parties involved. Some employees might argue that these commitments were in the nature of "independent contract of services" while others might characterize these commitments in the context of transfer of intellectual property over the materials. For many employees, the complaint is simply about the high rate of taxation.

The letters to Higher education institutions in Amhara Regional State (particularly that of Bahr Dar University) probably represent the best example of how positions shift over the same set of underlying facts on the ground. After a number of disagreements between university finance employees who tended to regard payments for the writing of modules as "income from employment" (thus falling under Schedule "A") and academic employees who asserted that these payments were not "income from employment," the Universities organized an ad hoc consortium of legal advisors to mount a challenge to the practice of regarding payments for the preparation of modules as "income from employment." The Universities (particularly Bahr Dar) were also concerned

about the negative impact of the withholding tax rates upon the motivation of staff members to write instructional materials. In any case, the Universities relayed their legal opinions to the branch office of ERCA (in Bahr Dar). In their opinions, the Universities argued that these payments were in the nature of payments for transfer of intellectual property rights (copyrights) over the instructional materials and should therefore be treated as "royalties" rather than as "income from employment." This argument of the Universities was able to sway ERCA at least provisionally as the following letter attests: [65]

> ... የሞጁል ዝግጅት የሥነ-ፅሁፍ ሥራ ለመሆኑ የዩኒቨርስቲው ሕግ አገልግሎት ባለሙያዎች ከሰጡት ማብራሪያ በላይ አሳማኝ ማብራሪያ ለማቅረብ መሞከር አስፈላጊ ሆኖ አላገኘነውም፡፡ ምክንያቱም አዋጅ ቁጥር 410/96 አንቀፅ 2(3) ጥበቃ የሚያደርግለትን ..ሥራ... ሲተረጉም መፅሐፍና ቡክሌት የመሣሉትን የስነ-ፅሁፍ ሥራዎች እንደሚያካትት ገልጻል፡፡ በዚሁ አዋጅ የተጠቀሱት መብቶች ያለአንዳች ቅድመ ሁኔታ ጥበቃ የሚደረግላቸው መብቶች ናቸው፡፡
>
> ስለሆነም ... መምህራኑ ከዩኒቨርስቲው ጋር በሚገቡት ልዩ ውል መሠረት የመደበኛ ስራቸው አካል የሆነውን የርቀት ትምህርት መማርያ ሞጁል አዘጋጅተው የሚያገኙት ገቢ ከማናቸውም የስነ ፅሁፍ ስራ እንደሚገኝ ገቢ ተቆጥሮ በገቢ ግብር አዋጅ ቁጥር 286/94 አንቀፅ 31 መሠረት ግብሩ ሊወሰን እንደሚገባው በመግለፅ ይህን አስተያየት የላክን ሲሆን....

When roughly translated, this reads:

> We did not think it was necessary to add to the written opinions submitted by the legal advisers [of the university] who made a convincing case for why modules constitute "copyrighted materials." As Article 2(3) [sic] of Proclamation No. 410/2010 stipulates, works protected as "copyrighted materials" include books, booklets and other materials. All works listed in the Proclamation are accorded copyright protection without any conditions.
>
> Thus... the income the university lecturers derive from the preparation and writing of modules after signing special contracts with the University should be treated as income from royalties and tax withheld in accordance with Article 31 of the Income Tax Proclamation of 2002 (author's translation).

The opinions of ERCA in the above case did not last for very long as persistent questions from various universities in different parts of Ethiopia finally forced ERCA to seek the helping hand of the Ministry of Finance and Economic

[65] Ethiopian Revenues Customs Authority, Bahr Dar Branch, Customers Services Business Process, 08/10/2001 E.C., in Amharic, unpublished

Development and in that proverbial case of curiosity killing the cat, the Ministry of Finance and Economic Development wrote letters which in effect reversed the initial hunches of ERCA in the above letter and brought payments for the writing of modules back to the fold of "income from employment" in many cases. The following Letter, addressed to Jimma University, is typical of the current opinion regarding payments for the writing of modules and other instructional materials in the Universities:

> ...ዩኒቨርስቲው ለቀጠራቸው ባለሙያዎች በመስጠት ላይ ያለው የሞጁሎች ዝግጅት ከገቢ ግብር አዋጅ ቁጥር 286/94 አንቀጽ 13 እና አዋጁን ለማስፈፀም በወጣው ደንብ ቁጥር 78/94 አንቀፅ 3 ሥር ከግብር ነፃ እንዲሆኑ ከተዘረዘሩት ውስጥ የማይካተት ገቢ በመሆኑ ከሠራተኞች ከወር ደሞወዝ ጋር እየተደመረ የሥራ ግብር የሚከፈልበት ገቢ መሆኑን እየገለፅን:: ዩኒቨርስቲው ለሠራተኞቹ የሞጁል ዝግጅት የሚከፍለውን ክፍያ በማስላት ከሠራተኞቹ ደመወዝ ጋር በመደመር ተገቢውን የሥራ ግብር ተቀናሽ በማድረግ ለታክስ ባለስልጣኑ መ/ቤት ገቢ ማድረግ የሚጠበቅበት መሆኑን በመግለፅ አስተያየታችንን እናቀርባለን::[66]

This reads:

> ... we have concluded that payments for the writing of modules are not exempted under Article 13 of the Income Tax Proclamation or under Article 3 of the Income Tax Regulations issued pursuant to the Proclamation and are therefore to be aggregated with the monthly salary of the employees. The University is therefore expected to compute the tax due after aggregating the payments for the writing of modules with the monthly salary of employees and deduct and transmit the tax deducted to the Tax Authorities (translation mine).

The opinion of the Ministry in the quoted Letter did not even attempt to address the question of whether the payment for the writing of modules was "income from employment" and took a rather curious position of characterizing the payments from the angle of whether these payments were "exempted" under the income tax laws. Having assured itself that these payments were not exempted under any of the "exemption" provisions of the income tax laws of Ethiopia, the Ministry took an unwarranted leap in reaching the conclusion that the income was therefore subject to tax under Schedule "A" of the Ethiopian income tax laws.

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[66] Ethiopian Revenues and Customs Authority, Letter written to Jimma University, 24 Megabit 2001 E.C, in Amharic, unpublished

With all due respect to the Ministry, the "exemption" provisions of Ethiopian income tax laws are a complete *non sequiter* in this case as none of the parties claimed that it should be exempted. Even if the conclusion were that payments for the writing of modules are income from employment, the Ministry should have analyzed the issue from the relevant provisions of the income tax laws of Ethiopia that might place these payments under Schedule "A" rather than under the other schedules of the Ethiopian income tax laws. The Ministry began from a non-starter – the exemption provisions – and on that account alone, its position was unwarranted, no matter what we might think about its conclusion.

In another Letter, written to Madda Walabu University, which was cc-ed to several other universities, the Ministry of Finance and Economic Development gave the following opinion:

> በገቢ ግብር አዋጅ ቁጥር 286/2003 አንቀጽ 2(12) እንደተመለከተው ለተቀጣሪ የተሠጠው ትርጉም እንድ የተወሰነን አገልግሎት ለመስጠት በውል የሚቀጠርን ሰው አይጨምርም፡፡ በመሆኑም የሌላ መስሪያ ቤት ሠራተኞች ራሳቸውን ችለው የተወሰነ አገልግሎት ማለትም የትምህርታዊ ፅሑፎች (ሞጁሎች) ዝግጅት፤ የትርፍ ሠዓት የክረምት መርሃ ግብር፤ ለሕክምና ተማሪዎች የሥራ ላይ ሥልጠና (በተግባር ትምህርት ወቅት)፤ በትርፍ ሠዓት ስራ የሚሰጥ የማማከር አገልግሎት ፤ እንዲሁም ልዩ ልዩ የትርፍ ሰዓት ሥራዎች በተወሰነ ጊዜ ውስጥ ለመስጠት ከዩኒቨርስቲው ጋር በሚያደርጉት ውል መሠረት ከሚያከናውኑት ተግባር የሚያገኙት ገቢ በመቀጠር የተገኘ ገቢ ነው ሊባል አይችልም፡፡ ሆኖም ግን የዩኒቨርስቲው ሠራተኞች በዩኒቨርስቲው ውስጥ ተመሳሳይ አገልግሎቶችን የሚፈፅሙ ሆነው ከተገኙ ከዩኒቨርስቲው ጋር የቅጥር ውል ያላቸው በመሆኑ የሚያገኙት ገቢ በመቀጠር የተገኘ ነው፡፡

Translated, this reads:

> As shown in Article 2(12) of Income Tax Proclamation No. 286/2003 (sic), the meaning given to "employee" does not cover a "contractor." Thus, if employees of other organizations are engaged under a specific contract to provide specific services, such as writing instructional materials (modules), part-time work for summer programs, practicum work for medical students, part-time consultancy work and other types of part-time work, the income of these employees may not be considered as arising from employment. If full-time employees of universities are, however, engaged to provide similar services, their payments for these services shall be considered as arising from employment as they are already engaged as employees of the universities (translation mine).

The letter written to Madda Walabu University repeats the familiar line of the tax authorities in these kinds of arguments. If you are a full-time employee,

every other relationship with your employer is defined by your status as a full-time employee. If you are a part-timer, the nature of the relationship is of no consequence. Your status as a part-timer defines you as a contractor as long as your engagement is one of provision of specific services. Although the Letter to Madda Walabu mentioned Article 2(12) of the Income Tax Proclamation, it, like many of the Letters written over the years, ended up setting aside the element of "direction and control" and turned the question of withholding on the prior relationship and status of the service provider with the employer.

The artificiality of the guidance provided by the Letter can be very cleverly set aside by a strategy in which universities have the modules written by outside staff while their full-time staff prepare modules for other universities. Like all artificial interpretations, this kind of guidance is a recipe for easy avoidance of the punitive tax rates of the Ethiopian income tax system under Schedule "A" in particular. It is also easy to note the difference between the letter written to Jimma University and the letter written to Madda Walabu University. The Letter written to Jimma University does not make any distinction between full-time and part-time module preparers while the one written to Madda Walabu makes the distinction between full-timers and part-timers. Thus, if a part-timer prepares modules for Jimma, her payments are taxed under Schedule "A" whereas a part-timer who prepares modules for Madda Walabu and other universities (to which the letter is copied) will be subject to 2% withholding.

5.4. Income from Employment vs. Income from other sources: the Less Common Cases of Conflict

We have reviewed the most common incidents of conflicts, but as the relationships between employees and employers are complex and intricate, so are some of the forms of income flows from employers to employees. The relationships between employers and employees cannot be reduced to the simple matrix of employment relationships, although that often forms the basis of their relationship. The relationships between employees and employers may at times be found in concurrence with the personal relationships of husbands and wives, of fathers and sons, mothers and daughters, debtors and creditors, shareholders and companies, writers and publishers, donors and donees, and so on.

Sometimes, these other relationships are so closely intertwined with the employment relationships that it is by no means clear whether the benefits flowing therefrom are income from employment or from the other relationships. In a schedular income tax system of Ethiopia, these questions are not cerebral jigsaw puzzles but real life questions that require careful consideration of all the elements surrounding each of these relationships and their bearings upon an employment relationship. They sometimes constitute the difference of paying taxes or not paying taxes or paying taxes at lower tax rates if we succeed in characterizing the income as flowing from other relationships. They also open up tremendous opportunities for tax planning by those sophisticated enough to understand the tax implications and thus to structure their relationships in ways that at times eliminate or at least reduce their tax liabilities.

How much these other relationships are mingled or intermixed with employment relationships in practice requires additional researches, but let's point out some specific cases in which the boundaries might, at least at first sight, be blurred for tax purposes.

One possibility or incident for conflict is between income from "employment" and income from "interest." Many employees are known to have organized credit unions which serve as saving financial institutions for the benefit of employees. As taxes are withheld from salaries and wages of employees, a certain amount is withheld monthly from the salaries of employees, which are then placed under the administration of employers for investment and provision of credit facilities to employee members of the credit unions. Employees are paid interest (at least interest accrues in favor of employees) and dividends every year from the saving funds of the credit unions. Some employers are known to borrow from the saving funds in return for the payment of interest.

One of the rare instances in which this kind of dispute found its way to courts involved the payment of interest by an employer on a provident fund. In **Shell Ethiopia vs. Inland Revenue Administration,** cited above,[67] Shell Ethiopia Ltd (the predecessor of Oil Libya) entered into a collective agreement in which the Trade Union in Shell Ethiopia allowed the Company to use (in effect lent)

[67] See Shell Ethiopia Ltd. v. Inland Revenue Administration, supra note 43

provident funds held in the name and on behalf of workers in return for the payment of interest at the rate of 7%. The then Tax Authority – Inland Revenue Administration (IRA) thought that Shell Ethiopia should have withheld the tax due on the interest paid for the use of the provident funds in the name of employees. Shell Ethiopia protested that it had no obligation to withhold tax on the interest, arguing that the interest was not income from employment but from interest, which was not taxable.

The Tax Appeal Commission at the time decided in favor of the Tax Authority and ruled that Shell Ethiopia Ltd was required to withhold tax on the interest, and this was confirmed by the then High Court. The case finally went on appeal to the Supreme Court, which reversed the decisions of both the Tax Appeal Commission and the High Court. The reasoning of the Supreme Court was that the payment constituted an interest and not an income from employment and therefore did not give rise to the obligation of the employer (Shell Ethiopia Ltd.) to withhold tax under Schedule "A". The Tax Appeal Commission and the High Court at the time considered the coincidence of the employment relationship as determinative of the nature of the income as arising from that of "employment" while the Supreme Court at the time quite sensibly thought the "employment relationship" was not the source of the income; the source of the income being the creditor-debtor relationship established between employees as a group and their employer giving rising to "interest."

The Shell Ethiopia case illustrates that disputes regarding income from employment or payments in the context of employment may raise questions as to whether in specific cases employers have the duty to withhold income taxes, or if they have to withhold income taxes, under which of the schedules, and sometimes if they have any obligation to withhold income taxes at all. Due to innovations in employment and industrial relationships, the situation is even going to get more complicated in the future.

In many parts of the world, and perhaps increasingly so in Ethiopia, many employees obtain benefits which are difficult to characterize as income solely from employment. The famous John Lewis model in England, for example, runs on the philosophy of full employee participation as board directors, managers

and shareholders of a business enterprise.[68] Employees of these types of companies obtain income from two principal streams, both of which are closely related: salaries or wages, and dividends. Employees may also be invited to purchase shares at less than market value or be guaranteed a repurchase of the shares at a certain fixed price even though the price of the shares has fallen in the market.[69]

In Ethiopian context, the conflict over "income from employment" vs. "income from dividends" arises frequently with respect to payments to corporate directors.[70] Some public companies have provisions for the payment of 10% of the profits of a company to corporate directors as an incentive and compensation for the latter's services.[71] These payments have divided opinions within the tax authorities.[72] Some are of the opinion that these payments should be characterized as "income from employment" and be subject to income tax withholding under Schedule "A" of Ethiopian income tax laws, while others have argued that these payments are in the nature of "dividends" as they are payments from the "net profits of the company."[73]

It has been reported that many companies and corporate directors are reluctant to pay income tax under Schedule "A" (for obvious reasons of the higher marginal tax rates under Schedule "A") and have only shown willingness to pay the 10% dividend withholding tax.[74] The tax authorities have blamed the problem on the lack of clarity and of details in the Ethiopian income tax laws.[75]

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[68] See Keith Bradley and Saul Estrin, "Profit Sharing in the British Retail Trade Sectors: The Relative Performance of John Lewis Partnership," The Journal of Industrial Economics, Vol. XL, September 1992, pp. 291-3004

[69] See Abimbola A. Olowofoyeku, James Kirk Bride and Deborah Butler, Revenue Law: Principles and Practice (3rd edition, 2003), Liverpool Academic Press, pp. 107-108

[70] See ከፋይናንስ ስራ አስኪያጆች ኮሚቴ ለህግ ባለሙያዎች ኮሚቴ ሙያዊ አስተያየት እንዲሰጥበት የቀረበ ሪፖርት፣ ሚያዚያ 2003 ዓ.ም. ያልታተመ፣ see also Revision Proposals of the Large Tax Taxpayers' Branch Office, ERCA, Addis Ababa, 2004 E.C., in Amharic, unpublished

[71] Companies are allowed under the Commercial Code of Ethiopia (1960) to allocate a fixed annual remuneration and a specified share in the net profits of financial year, which may not in any event exceed 10% of the net profits; see Commercial Code of Ethiopia (1960), Article 353

[72] Revision Proposals of the Large Tax Taxpayers' Branch Office, supra note 70

[73] Ibid

[74] Ibid

[75] Ibid

Unless the boundaries are defined properly through detailed rules, the incidences for tax planning and abuse can be numerous.

5.5. Withholding Practices: Case Studies of Three Higher Education Institutions

In view of the divergent interpretations sampled above, divergent practices of withholding taxation in various organizations and institutions are to be expected. In any case, three higher education institutions in Addis Ababa have been selected for purposes of comparing how similar payments to employees and part-time employees are treated for tax purposes. Two of them are public institutions while one is a private higher education institution. The names of the three higher education institutions are withheld and represented instead as PuB1, Pub2 and PrV1. Some of the most common forms of payments to employees of higher education institutions are used for purposes of comparing how these institutions withhold taxes upon the various payments to employees and independent contractors. It must be noted at the outset, however, that some of these institutions might have changed their practices in some respects after the interviews were conducted. Some of the institutions have been known to shift from 2% withholding tax under Schedule "C" to withholding under Schedule "A" or vice versa after receiving guidance letters from the authorities.

Table 1.2: Comparison of Withholding Practices on Sample Payments in Three Higher Education Institutions of Addis Ababa (valid up to March, 2012)

No	Services for which Payments are Made	Full time Employee			Part-time Employee		
		PuB1	Pub2	PrV	PuB1	Pub2	PrV
1	Day-time teaching (regular)	Schedule "A"[76]	Schedule "A"	Schedule "A"	Schedule "A"	2% withholding	Schedule "A"

[76] Institutions that treat payments as falling under Schedule "A" often follow the rules of aggregation in the Income Tax Proclamation; if the employee is a full-timer, the institution aggregates the income from special contracts with her full-time salary; if the employee is a part-timer, the institution may require the employee to bring a certificate of employment and salary from her full-time employer for purposes of aggregation; some of the institutions have been known to have insisted on their part-time "employees" producing a certificate of employment or else…

2	Part-time (extension)	Schedule "A"	Schedule "A"	Schedule "A"	Schedule "A"	2% withholding	Schedule "A"
3	Provisions of short term training	Schedule "A"	Honorarium (paid net of tax)[77]	2%	Schedule "A"	Honorarium (tax free)	2% (Schedule "C")
4	Presentation of conference papers	Schedule "A"	Honorarium (tax free)	2%	Schedule "A"	Honorarium (tax free)	2%
5	Advising/invigilation/examination boards	Honorarium (paid net but tax paid by PuB1)	Honorarium (tax free	2%	Honorarium (paid net but tax paid by Pub1)	Honorarium (tax free)	2%
6	Consultancy services	Schedule "A"	2% withholding	2%	Schedule "A"	2% withholding	2%
7	Translation services	Schedule "A"	2% withholding	2%	Schedule "A"	2% withholding	2%
8	Editorial services[78]	Schedule "A"	5% royalties tax	2%	Schedule "A"	5% royalties tax	2%
9	Assessment of research papers/scholarly articles	Schedule "A"	Honorarium (tax free0	2%	Schedule "A"	Honorarium (tax free)	2%
10	Preparation of modules[79]	Schedule "A"	5% royalties tax	2%	Schedule "A"	5% royalties tax	2%
11	Writing Books	Honorariums (paid net but PuB1 reportedly pays tax)	5% royalties tax	5%(royalties)	Honorariums (paid net but PuB1 pays tax)	5% royalties tax	5% (royalties tax)

[77] Merriam Webster's Dictionary describes "honorarium" as "a payment usu. for services on which custom or propriety forbids a price to be set;" see Webster's Ninth New Collegiate Dictionary, 1984

[78] PuB1 finance staff may apply 5% under special advisements

[79] PuB1 finance staff may deduct 5% royalties tax under advisement

Source: this table is a summary of interviews conducted with the finance staff of the respective higher education institutions in Addis Ababa

It can be seen from the table above that PuB1 is the harshest or the most faithful withholder of taxes (depending on who is looking at these practices). The rule in PuB1 is to treat virtually every payments made for provisions of services as a payment to employees – subject to the rules of withholding of income tax under Schedule "A." The only situation in which PuB1 appears to concede a ground is when it pays what it calls "honorariums," which according to PuB1's internal "rules" are to be paid net of tax. But even then, it is only because PuB1 ostensibly agreed to bear the tax on behalf of the recipients that the latter do not see the tax withheld – which means that the gross payment in case of honorariums is far higher than the net payments because the taxes are concealed from the recipients.

On the contrary, PuB2 appears to have the most lenient rules of withholding particularly as against part-time providers of services. Except in the case of day-time and extension teaching duties, PuB2 treats most of the payments for specific services as either services of independent contracts (subject to 2%), or as honorariums (tax free as far as the recipients are concerned) or sometimes as royalties for preparation of modules and books (5% final tax). The rules for honorariums in PuB2 are based on its own internal rules of payments which privileged a number of payments as honorariums (e.g. payments for short term training, conference papers, and advising).

The private higher education institution identified as PrV shares many features of PuB2. But there are some differences. PrV does not seem to have what PuB1 and PuB2 call "honorariums." PrV appears to construe payments for publications more narrowly than PuB2 in that PrV treats payments for publications as "royalties" only when the writing contributions are published. That is why writing contributions in the form of modules, which are not published, are not eligible for "royalties," while contributions in publishable journals or books of PrV are eligible as "royalties" and therefore subject to 5% final withholding tax. PrV treats writing contributions for unpublished manuscripts and monographs as independent contract services and withholds 2% tax from payments made in consideration of these services.

It is quite evident that the three higher education institutions diverge quite significantly even on payments that are virtually identical on factual grounds. The paradoxical situation of it is that part-timers who teach the same courses, the same number of students and of hours are treated as employees in PuB1 and PrV and independent contractors in PuB2. By the same token, individuals who write modules for PuB1, PuB2, and PrV, respectively, are subject to income tax under Schedule "A" (the income is aggregated with their regular employment income), under Schedule "D" (royalties, 5%), and Schedule "C" (2% withholding). If a writer of a module in PuB1 has a regular salary above 5000 (the top marginal income bracket), the writer's salary is already in the 35% marginal tax rate range, which means that a writer of modules in PuB1 will be subject to 35% tax rate for all of the payments received for the writing of modules. Even if we assume that the 2% withholding under Schedule "C" is not a final tax, the differences among the three institutions for identical payments are quite astonishing.

6. What is to be Done? Some Modest and Some Not-so-Modest Proposals

It is clear from the analyses above that none of the laws in this regard (the Proclamation, Directive, Circular Letter and the private letters) have provided clear set of solutions to resolve the disputes arising in connection with the withholding of taxes on employee payments. The Proclamation employs a very subjective and difficult to pin-down criteria: whether employer exercises "direction and control" over an employee. The Proclamation does not provide details on indicators or signposts of "direction and control," virtually leaving it up to the withholding agents to determine whether there is employment based on the facts and circumstances of each case. This state of affairs is largely responsible for all the arbitrary and whimsical decision-makings that characterize withholding taxes in various institutions, most notably in the higher education institutions in Ethiopia.

While one would have expected the subsidiary pieces of tax legislation to provide details on matters of "direction and control," all the subsidiary pieces of legislation have gone on a path that was not anticipated by a more exacting and substantive language of the Proclamation. The subsidiary pieces of legislation –

the Regulations, the Directives and the Circular Letters as well as private letters – essentially sought to resolve the problems by applying "easy" parameters that are not necessarily consistent with the spirit and language of the Income Tax Proclamation. The Directives and Circular Letters have drawn the boundaries based on arbitrary indicators like "whether the person providing the specific service is a full-time employee or a part-timer" or "whether the service involved is a specific service or a continuous one," and "whether a person providing specific services possesses a TIN and sometimes a business license." These indicators or guideposts are easy to apply but, as we have seen in this article, they have led to some arbitrary conclusions regarding tax burdens.[80]

In view of the cacophony of instructions issued by the tax authorities over the years, it is really not surprising that various institutions have followed wildly divergent practices on withholding of taxes. Combined with the subjectivism that dominates the practice of withholding taxation, the conflicting signals coming from the tax authorities have only worsened the situation on the ground, resulting in the violation of both principles of horizontal and vertical equity. If the Ethiopian income tax system is to restore some modicum of fairness to the administration of withholding taxation, those in charge of Ethiopian tax administration must realize that there is a need for fundamental change to the way withholding taxation is conceived and administered on the ground. The discriminatory treatments of similar types of payments in various institutions should provide pause for rethinking about the laws and the practice in this regard. We propose three major solutions, which can be implemented in three phases.

6.1. The First Proposal: Provide Uniform Guidance on Elements of "direction and control"

The simple and obvious solution is of course to clarify the element of "direction and control" through subsidiary pieces of legislation. It is important to provide details about instances in which "direction and control" are said to exist (the facts and circumstances of control and direction), and provide for as many

[80] It will be interesting for economists to study the efficiency cost of taxation in these instances; it does not require much research to state that these discrepant practices discourage undertaking certain kinds of work

examples as can be imagined so that the current disturbing discretionary powers of withholding agents are cut down considerably. The Directives and Circular Letters that have surfaced so far have essentially adopted simple parameters that have ended up practically in setting aside the basic requirement in the Income Tax Proclamation, that is, "direction and control".

The Directives and Circular Letters have continued to be operational not because they are consistent with the language and spirit of the Income Tax Proclamation but because it is not customary to challenge directives and circular letters when they are found to be inconsistent with higher ranked laws and it is even less customary for courts to overturn directives and circular letters on grounds of contravening the mandatory provisions of higher-ranked laws.

It is not snobbish to claim that the solutions in this regard are only a click away. Many other income tax systems have struggled with the same set of issues on the question of what types of income should be characterized as "income from employment" and what types should not. The Courts in the United States have developed a number of tests to distinguish cases of employment from cases of "independent contract of services" and the Internal Revenue Service (IRS, the equivalent of ERCA in Ethiopia) has thoroughly simplified the work of withholding agents by culling what are known as 20-factor tests from a number of relevant court decisions.[81] The courts in the UK have similarly attempted to provide black letter tests for the convenience of withholding agents.[82] The settings in Ethiopia might be much different from the UK and the United States, but the facts and circumstances of employment in Ethiopia are much simpler than that of the UK and the United States.

Apart from individual countries, Model Tax Conventions and Commentaries have also summarized the "essential" facts of "employment" from the experience of a number of countries.[83] The doctrine of "substance over form," as elaborated in these Conventions and Commentaries, can also be an

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[81] IRS Publication 15- A (2012); see also Myra H. Barron, "Who's an Independent Contractor? Who's an Employee?" 14 Labor Lawyer 457 (1999)

[82] Olowofoyeku et al, supra note 69, pp. 81-85; see also John Tiley, supra note 1, pp. 219-220

[83] See United Nations, Department of Economic and Social Affairs, UN Double Taxation Convention between Developed and Developing Countries, United Nations, New York, 2011, p. 246

instructive source of inspiration for Ethiopian tax administration.[84] It is incumbent upon the Ethiopian tax administration to develop however many tests it deems appropriate to help employers distinguish cases of employment from other relationships based on the comparative experience of mature income tax systems.

Uniform standards do not guarantee consistency of the standards with the general standard laid down in the Income Tax Proclamation. The tax authorities are not impartial bodies for developing standards that are fair to all parties involved. It is difficult to tell if the tax authorities were not motivated by considerations of revenue in turning out many of the so-called "guidance letters" to numberless withholding agents in the past.

The process of establishing uniform standards must therefore be supplemented and controlled by the intercession of courts. Employees, just like business persons, should be able to challenge withholding taxes and take both withholding agents and the tax authorities to courts. The threat of court challenge alone has tremendous impact upon the behavior of both withholding agents and tax authorities. Knowing that the person from whose income withholding taxes are deducted can challenge them before courts, withholding agents and tax authorities will no longer take the process as cavalierly as they used to and make all sorts of arbitrary decisions in withholding taxes.

6.2. The Second Proposal: a Flat Withholding Tax on Additional Income of Employees

The root of the controversies on withholding taxes can be traced to the structural defects of the Ethiopian income tax system. The income tax brackets and rates of the Ethiopian income tax system may appear uniform, but these apparent uniformities have not removed some of the structural discriminations inherent in the administration of schedular income taxation in Ethiopia. There are still huge differences in tax burdens between income falling under Schedule "A" and income falling under the other schedules. When employees demand the 2% withholding tax instead of aggregation under Schedule "A," they are not just making scenes to score academic points. Most employees (unaided by subtle

[84] See ibid

knowledge of tax laws) know that there is a huge difference between a 2% withholding tax (which is for many practical reasons almost final) and an aggregation under Schedule "A" (which for many academic employees means a 35% withholding from the payment for specific work due to the low income thresholds). Just as it does not take to be a physician to feel the pain of an ailment, it does not really take any special knowledge of tax law to feel the pinch of withholding under higher rates of taxation.

While the eventual solution to this problem is to be found in the overhaul of the schedular income tax system of Ethiopia, solutions short of the overhaul must be found. Many will agree that employees already pay a lot in income taxes, and certainly compared to other income earners (lessors, traders, shareholders, etc), employees are some of the most productive and effective sources of revenue for the governments of Ethiopia.

Until some parity is established in tax burden distributions among various categories of income earners (employees, lessors, professionals and traders, shareholders, etc), it is important to provide a solution that phases out when the income tax system is thoroughly reformed. One solution is to design a flat tax rate (under Schedule "D") for income from specific and additional services by part-time as well as full-time employees. This solution will cut down the administrative cost of characterizing income as either from employment or self-employment. It will also remove the temptation for characterizing these types of income as income from self-employment, thereby making the work of withholding-agents considerably easier. More importantly, it will remove the main reason why employers as well as employees fight over the characterization of income. Finally, it will restore some modicum of fairness to the existing income tax system as it applies to employees –part-time as well as full-time.

6.3. The Third Proposal: Structural Overhaul of the Schedular Income Tax System of Ethiopia

The third solution is a long term one, which can only be mentioned in passing here: making sources of income irrelevant for income tax purposes in

Ethiopia.[85] The root cause of most controversies regarding the appropriate withholding taxes in Ethiopia is the schedular income tax structure of Ethiopia, which takes the source as the ultimate decider of tax burdens in many instances. There are enormous differences in tax burdens between aggregation under Schedule "A", and withholding taxes under Schedule "C" (the 2% withholding tax) and Schedule "D" (the 5% royalty tax) or Schedule "D" (10% dividend taxation). Many employees are instinctively aware of these enormous differences and naturally try to persuade the withholding agents to deduct the 2% tax or the 5% tax, as the case may be. Those employees who can afford to forego the extra income derived from intermittent services simply swear never to undertake those extra duties. Others may be willing to grind the routine out regardless of the tax burden, but they are probably not showing as much enthusiasm in their extra work.

The structural overhaul of the schedular income tax structure of Ethiopia can take many forms and it will take another research of its own to go into details of that nature. But it can be suggested in passing that Ethiopia either i) revise its income tax laws within the framework of the schedular income tax structure in such a way that the burdens among the various sources of income are at least comparable, if not outright equal; or ii) introduce a flat income tax system like many Eastern European countries so that all sources of income are subject to the same flat tax rate regardless of the source of income.[86]

7. Concluding Remarks

The scope of the various schedules of Ethiopian income tax is a source of controversy in many places. Since Ethiopian income tax bases income tax liability exclusively upon the source (expressed mostly in schedules), this structure of Ethiopian income tax is not only a source of disputes in various places but also of huge tax planning opportunities by those having the resources to detect and manipulate the loopholes of Ethiopia's income tax laws. This article has attempted to highlight the extent of the problems by reference to one

[85] How long this is going to take depends on how quickly tax reforms are pushed through; going by how easily the Value Added Tax was introduced in 2002, that time might be sooner than we think.

[86] For the insights on the flat tax model, see OECD, Fundamental Reform of Personal Income Tax (2006), OECD Tax Policy Studies, No. 13, Paris

of the sources of income subject to withholding taxation in Ethiopia: income from employment under Schedule "A".

It is easy to see why the taxation of this source and related incomes can become a source of controversy in various working places. Employees wear "many hats" like other members of society. Employees may be lessors, traders, licensed professionals, writers and/or inventors, shareholders, savers/depositors, property owners, etc. The current income tax structure of Ethiopia is such that employees pay multiple but separate individual income taxes when they generate income from their multiple activities. Apart from the withholding income tax under Schedule "A," an employee who rents her house pays an income tax under Schedule B, who is engaged in business pays tax under Schedule "C," who publishes a book and derives royalties, under Schedule "D," obtains dividends from shares in companies under Schedule "D", earns interest from bank deposits under Schedule "D," etc. None of these "income" taxes are related with one another although the person who derives these various types of "income" is one.

The various disputes that arise in connection with the appropriate withholding taxes on supplementary forms of income in the context of employment arise from this basic structure of the Ethiopian income tax system. The differences in tax burdens at times are so huge that employees and employers (through their agents) frequently disagree over the characterization of the source of income. The withholding practices have also become a source of outrageous discriminatory treatments of the same forms of payments in various places. Employees who have been subject to less onerous tax rates have been more than pleased to be treated as such while employees who have been subject to heavier burdens of tax on their supplementary income are observed complaining about the impact of the tax upon their work ethic and their desire to assume extra work.

Apart from design issues, which, as seen in this article, are considerable, it is important to appreciate the nature of the problems involved and the professional background and training of those tasked with withholding taxes on a daily (or monthly) basis. The technical language of the Income Tax Proclamation is intelligible (if at all) only to those having adequate training in law, particularly

tax and employment law. The irony of the whole process of withholding taxation in Ethiopia is that actual decisions are made by agents who are least qualified to decide cases where "direction and control" are said to exist and cases where these are said not to exist. Since it is not customary to seek legal opinions until late after disputes reach courts, it is likely that most withholding agents decide these cases without bothering about the legal implications of their decisions. The withholding agents are moved to seek the opinions of the tax authorities largely on the instigations of the persons from whose income tax is withheld, and as many of the queries show, the authorities are drawn into these questions largely because many withholding agents (ill-trained as they are in matters of the law) are completely unaware of the requirements of the Income Tax Proclamation or uncertain about the taxes that should be withheld on so many different types of payments made in the context of employment. The only surprise has been that the authorities have chosen a more difficult path of responding to individual queries as they arise rather than providing guidance in all matters pertaining to withholding on income from employment and other related incomes.

It is quite clear that these questions will be with us for as long as the structure of income taxation lacks neutrality with respect to the sources of income taxation. Until design issues are resolved as to make sources of income irrelevant for tax purposes in Ethiopia, it is important to provide withholding agents with detailed guidelines either through directives or advance rulings so that the agents will have little discretion in making judgments about what withholding tax rates are appropriate in specific situations. It is impossible to anticipate all sorts of payments that are made in various working places, but it is quite possible to cover most of them in the guidelines. It is quite possible to reduce the number of discretionary and arbitrary decisions that are made in this regard, decisions that have been based not on the substance of the services performed or the overall relationships of the parties but on some arbitrary factors like whether the work is full-time or part-time. The tax authorities have avoided the substance of the contractual relationships and opted for the formal aspects of contracts (such as the status of the employee as a part-timer or full-timer). This cavalier approach to the question will not do. Instead of writing letters for withholding agents as the queries pour in, the tax authorities should approach the problem with utmost

seriousness, conduct research and provide guidance that puts many (if not all) of the questions to rest.

In this regard, it is incumbent upon the tax authorities to ensure that their guidelines are consistent with the language and spirit of the Income Tax Proclamation. Simple or easy-to-follow guidelines need not and should not set aside the meaning of "employment" vis-à-vis "independent contract" as set down in the Income Tax Proclamation. If you don't like the law, the right approach is not to breach it, but conduct yourself in accordance with its dictates. If you don't like to conduct yourself in accordance with its dictates, the right approach is not to write the law yourself, but to have it written by those empowered to make laws, in this case, the House of Peoples' Representatives.