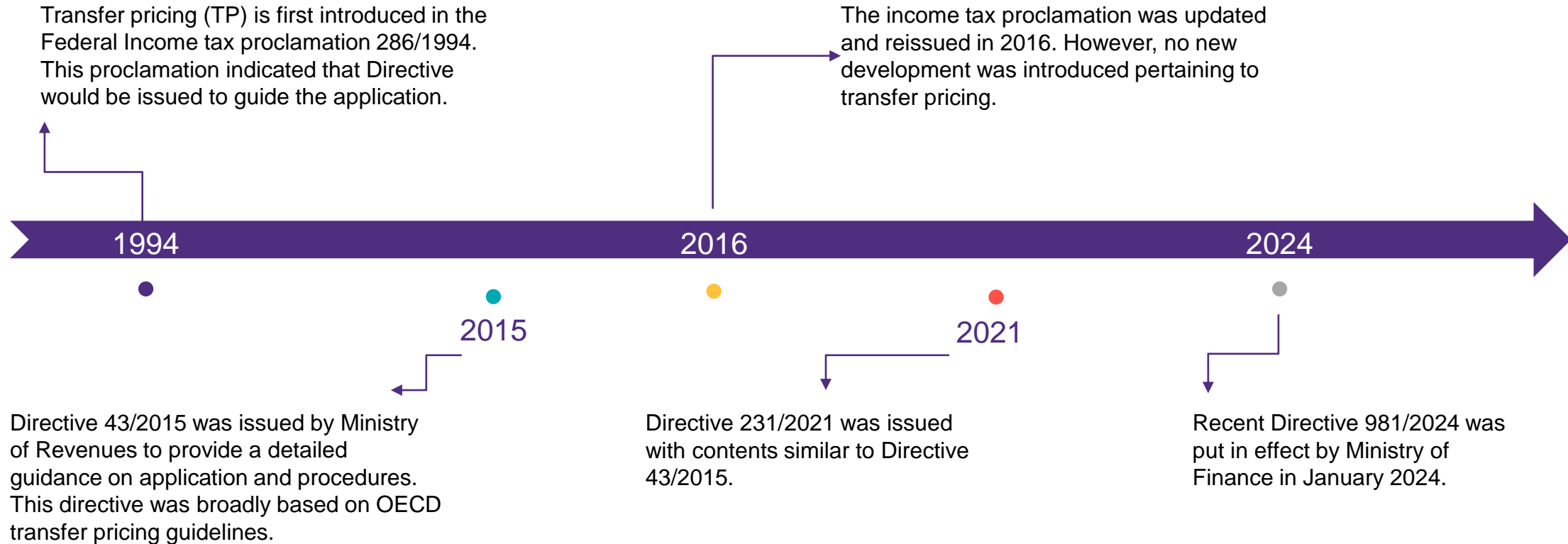


Transfer Pricing policy in Ethiopia

Grant Thornton Ethiopia



Key developments in transfer pricing



Introduction: Transfer pricing

Transaction between related parties is expected to be carried out based on arm's length principle. The Federal income Tax Proclamation No.979/2016 article 79 allows the Ministry of Revenue in respect of any transaction that is not an arm's length to distribute, apportion, or allocate income, gains, deductions, losses, or tax credits between the parties to the transaction as is necessary to reflect the income, gains, deductions, losses, or credits that would have been realized in an arm's length transaction.

To guide the proper implementation of Transfer pricing The Ministry of Finance issued Transfer price directive that governance transaction of goods, service and intangible properties with related parties.



Introduction: Transfer pricing

Who are 'Related parties'?



According to the Ethiopian Tax administration proclamation 983/2016 two parties are related if one person is expected to act in accordance with the directions, requests, suggestions, or wishes of the other party, or both parties are expected to act to the wishes of a third party. Further, the following are considered to be related person;

An individual and a relative of the individual unless the tax office is satisfied that neither person may reasonably be expected to act in accordance with the directions, requests, suggestions, or wishes of the other;

A body and a member of the body when the member, either alone or together with a related person or persons under another application of this Article controls either directly or through one or more interposed bodies 25% or more of the rights to vote, dividends, or capital in the body; and

Two bodies, if a person, either alone or together with a related person or persons under another application of this article, controls, either directly or through one or more interposed bodies, 25% or more or more of the rights to vote, dividends, or capital in both bodies.

Introduction: Transfer pricing

Key Principles

Arm's length principle - transactions between related parties have to be priced as if the parties were independent/unrelated engaging in comparable transactions, i.e. at an arm's length.

Comparability of Transactions - transactions within the related parties should be comparable against transactions between unrelated parties.

- Controlled and uncontrolled transactions are comparable if none of the differences between the transactions could materially affect the factor being examined in the methodology e.g. price or margin, or if reasonably accurate adjustments can be made to eliminate the material effects of any such differences.



Transfer pricing

The Ethiopian transfer pricing policy structured by Ministry of Finance Directive 981/2024 consists of the following main focus areas.

1. Scope
2. Comparability analysis
3. Sources of comparable transaction information
4. Selection of Transfer pricing methods, and
5. Transfer pricing methods

Transfer Pricing

1. Scope

The transfer pricing rules in Ethiopia is only applicable for related parties having an annual turnover of more than ETB 500,000.

2. Comparability Analysis

The key principle of comparability, where transactions between related parties (controlled transaction) should be comparable against transactions between unrelated parties (uncontrolled transaction), undertaking a comparable transaction under comparable circumstances.

Uncontrolled transaction is said to be comparable to a controlled transaction if:

- There's no significant difference between the two transactions that would materially affect the financial indicator being examined ((e.g. price or margin).
- Where differences exist, reasonably accurate comparability adjustment is made to the relevant financial indicator of the uncontrolled transaction in order to eliminate the effects of such difference on the comparison.



Transfer Pricing

2. Comparability Analysis (Cont.)

When analyzing the comparability of controlled transactions with uncontrolled ones, the transfer pricing policy requires the following essential points to put into consideration to increase the reliability of the analysis:

- The characteristic of the good or service,
- The functions undertaken by each person with respect to transactions, also considering assets used and risk assumed,
- The contractual terms and conditions of the transactions,
- The economic and market circumstances where the transactions took place, and
- The business strategies used by the parties to the transactions.

Adjustment

The transfer pricing policy allows comparability adjustments to be made if it is expected to increase reliability of the result and should be made taking the materiality of the difference, the quality of the data to be adjusted, the purpose of the adjustment and reliability of the approach to be used for the adjustment into consideration.



Transfer Pricing

3. Sources of comparable transaction information

A comparable uncontrolled transaction is a transaction between two independent parties that is comparable to the controlled transaction (transactions between related parties) under examination.

We can find comparable uncontrolled transactions from two sources:

- Internally – transaction between one party to the controlled transaction and an independent party.
- Externally – comparable transactions which none of the parties are a party of (between two independent enterprises).

4. Selection of Transfer Pricing Methods

When selecting one of the applicable transfer pricing methods, the selection process should be supported by a proper analysis of the following considerations while keeping consistency with the arm's length principle.

- I. Strengths and weaknesses of the methods
- II. Appropriateness of the method with regards to the nature of the controlled transaction,
- III. Availability of reliable information to apply the selected transfer pricing method, and
- IV. Degree of comparability of the uncontrolled and controlled transactions including reliability of comparability adjustment, if any.

Transfer Pricing

5. Transfer pricing methods

The transfer pricing Directive no. 981/2024 lists approved transfer price methods and allows entities to choose in determining the arm's length price. The Directive also allows a taxpayer to use **other methods**, provided that the taxpayer clearly demonstrates that none of the above can be reasonably applied.

01

Comparable uncontrolled price method

Comparing the price of controlled transaction **vs** similar uncontrolled transaction.

02

Resale Price method

Comparing resale margin (profit) generated by a buyer in the controlled transaction reselling the product in an uncontrolled transaction **vs** the resale margin in similar uncontrolled purchase and resale transactions.

03

Cost Plus method

Comparing the markup on direct and indirect costs incurred in the supply of goods or services **vs** the markup of such costs incurred in an uncontrolled transaction

04

Transactional Net-Margin method

Comparing the net profit margin relative to a base (sales, cost or assets) of one party in the controlled transaction **vs** the net profit margin relative to the same base of a party in an uncontrolled transaction.

05

Transactional Profit Split method

Determines the net profit/loss from controlled transactions and split the profit/loss on the basis that independent parties in an uncontrolled transactions would expect to earn/incur from engaging in such transaction.

Other significant matters

Other than the main areas seen previously, the following are additional matters that needs focus.

1. Advance pricing arrangement
2. Service Transactions,
3. Transfer pricing policy of intangibles, and
4. Transfer pricing documentation requirements

Other significant matters

6. Advance Pricing Arrangement

The transfer pricing directive 981/2024 allows taxpayers to request an advance transfer pricing arrangement with the tax authority to determine appropriate set of criteria (e.g. method, comparable...) for the determination of arm's length conditions over a fixed period of time. The arrangement could minimize transfer pricing disputes between taxpayers and the authority; however, the commencement of this practice is expected to be fixed by Ministry of Finance circular.

7. Service transactions

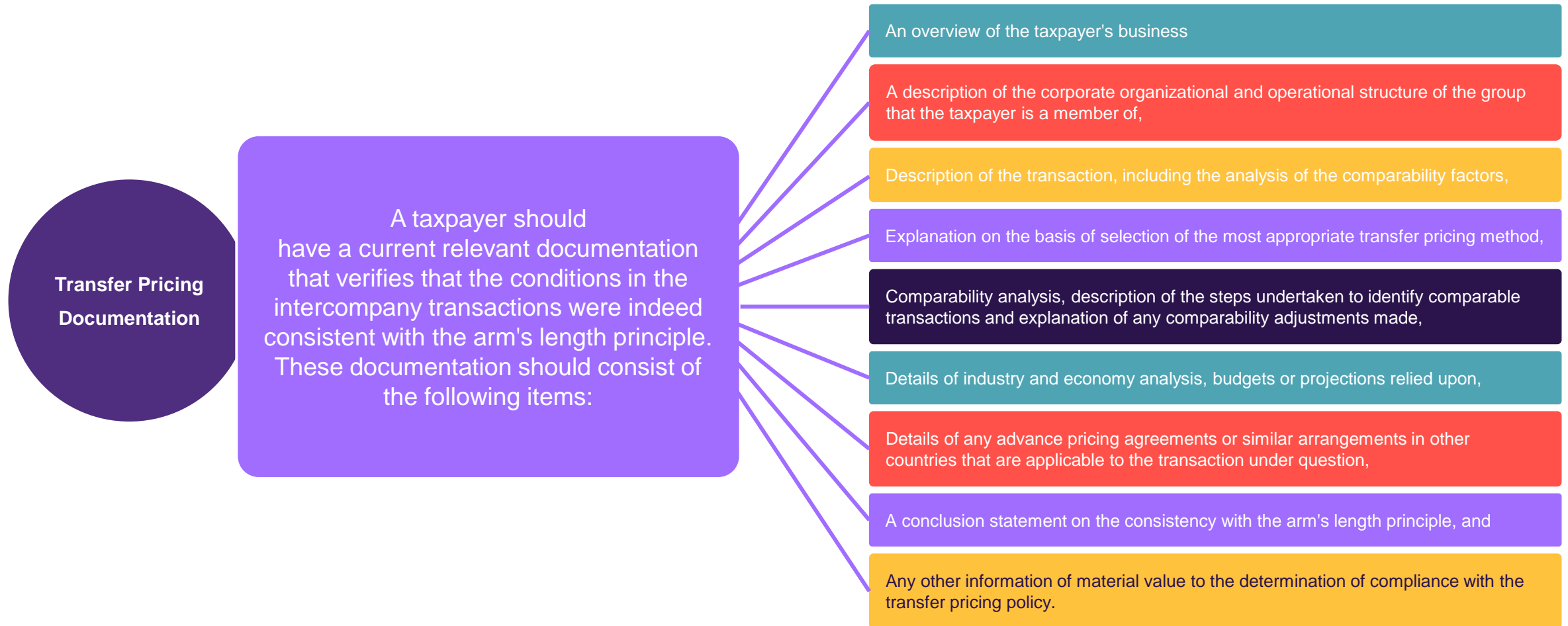
Service charge between related persons is required to be consistent with the arm's length principle and the charged should be for actually rendered service. Service transactions are deemed to be inconsistent with the arm's length principle if it is provided by the related party solely because of the shareholder's ownership interest in the related party. For e.g. costs related to shareholder meetings, issue of shares, remunerations to the supervisory board etc...

8. Transfer pricing policy of intangibles

Intangible property transaction includes sales and other transfer arrangement for provision of intangibles including patents, copyrights, formulas, process, design, model, plan, trade secret, know-hows and assets with similar natures.

- Related party transactions involving these intangibles are deemed to be consistent with arm's length principle if unrelated parties in similar circumstances would be willing to accept the pricing.
- While considering comparable uncontrolled transactions special considerations such as benefits from the property, geographical limitations on the exercise of rights, the character of the right transferred (exclusive or not) and participation right of the transferee to develop the intangible shall be taken into account.

Other significant matters



Other significant matters

10. Filing Requirement

- An entity is required to maintain transfer pricing documentation to verify transactions are consistent with the arm's length principle. If failed to do so, the entity will be liable for 20% of the tax payable amount as a penalty for non-compliance. However, if no tax is payable for the period, the penalty will be ETB 20,000 birr as stated on the Federal Tax Administration proclamation.
- Documentation shall be provided within 45 days when a written request is issued by the tax authority.

Transfer pricing: Current Practice in Ethiopia

- The current application largely depends on demonstrating that the transaction is at an arm's length and is supported with sufficient documentation. However, the lack of relevant market data poses a significant challenge on organizing such transfer pricing documentation for local transactions.

Applicable Guidance

- The transfer pricing directive accepts Organization for Economic Co-operation and Development (OECD) Transfer pricing guidelines for Multinational Enterprises and Tax administrations as relevant source of interpretation.

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