



Tax Alert

Ethiopia Transfer Pricing Directive No. 981/2024 effective January 2024

Introduction

The Ethiopian Ministry of Finance (MoF) has issued directive no 981/2024 (The Directive) which contains new transfer pricing rules effective January 2024. This Directive repeals the Transfer Pricing Rules Directive No 43/2015.

The Directive has been issued in line with the transfer pricing provisions under Section 79 of the Federal Income Tax Proclamation No. 979/2016 (ITP), and is substantially aligned to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. It provides detailed transfer pricing rules to guide the pricing of controlled transactions, in line with the provisions of Article 79 of the ITP which concerns the pricing of international and domestic transactions between related persons whose annual turnover exceeds Birr 500,000.

The following are the key provisions covered under The Directive;

Transfer Pricing Documentation: The Directive provides that a taxpayer must have contemporaneous documentation that verifies that the conditions in its controlled transactions for the relevant tax year are consistent with the arm's length principle. Documentation for a relevant tax year is considered to be contemporaneous where it is in place at the statutory tax return filing date.



The documentation should contain details on the taxpayer's business operations, corporate and organisational structure, the controlled transactions, selection of the most appropriate method, comparability analysis, industry and economic analysis and details of any advance pricing agreements or similar arrangements in other countries that are applicable to the controlled transactions.

Application of The Arm's Length Principle (ALP): The ALP is the cornerstone of transfer pricing and dictates that pricing of transactions between related entities should mirror those between unrelated parties. This, the taxable income of a taxpayer engaging in related party transactions must accurately represent the fair market value and should be consistent with what unrelated parties would agree upon in comparable circumstances.

Comparability Analysis: Assessing comparability between controlled and uncontrolled transactions involves evaluating property or service characteristics, functions with respect to the transactions, contractual terms, economic circumstances, and business strategies. Adjustments are made for material differences to enhance reliability.

Transfer Pricing Methods: Approved methods such as Comparable Uncontrolled Price, Resale Price, Cost Plus, Transactional Net Margin, and Transactional Profit Split ensure consistency and accuracy in transfer pricing evaluations. Taxpayers may use alternative methods if approved ones are deemed inapplicable.

Transactional Profit Split Method and allocation of profits: The Directive provides for the use of the Transactional Profit Split Method to allocate residual profits in a transaction where some of the functions have been remunerated under the other transfer pricing methods. The criteria used for this allocation should align with the arm's length principle and depend on the specific facts and circumstances of the case.

Transfer Pricing Adjustments: The Directive stipulates that adjustments by the Tax Authority shall only be made whereby the net effect is an increase in the Taxpayer's taxable income.

Arm's Length Range: An arm's length range is a range of relevant financial indicator figures (e.g. prices, margins or profit shares) produced by the application of the most appropriate transfer pricing method to a number of uncontrolled transactions.

The Directive provides the median or 50th percentile, of the arm's length range as the basis upon which transfer pricing adjustments shall be made by the Tax Authority.

Advance Pricing Arrangements (APA): An APA is a formal agreement between a taxpayer and tax authority regarding the transfer pricing method and related pricing adjustments for related party transactions. The Directive provides that a taxpayer may request the Tax Authority to enter into an APA to determine appropriate set of criteria for the determination of the arm's length conditions for certain future controlled transactions over a fixed period of time, not exceeding five years and subject to approval and periodic review.

Specific Transaction Guidelines: The Directive provides distinct guidelines governing service transactions and transactions involving intangible property (IP). Service charges between related persons should align with actual services rendered and the arm's length principle. Further, shareholder service costs shall not be allowable for tax purposes. IP transactions shall consider factors such as expected benefits, further development of the IP by the transferor, geographical limitations, and transferee rights.

Corresponding Adjustments for domestic transactions: Corresponding adjustments mitigate double taxation risks. The Directive provides for corresponding adjustments in domestic transactions, where if an adjustment is made by the Tax Authority under article 79(1) of the ITP to the taxable income of a taxpayer in relation to domestic transaction, then, the Tax Authority shall make an appropriate adjustment to the taxable income of the other party to the transaction.

Corresponding Adjustments for international transactions: Where an adjustment results in the taxation in another country of an amount of profits on which the party to the controlled transaction is a taxpayer in Ethiopia and has already been charged to tax in Ethiopia, the tax authority shall examine the consistency of an adjustment made by the tax authority of another country that has a double taxation treaty with Ethiopia and make a corresponding adjustment for the taxpayer in Ethiopia.

Administrative Penalties: Article 19 of The Directive introduces the administrative penalties for non-compliance with the requirement to maintain transfer pricing documentation.

Failure by a taxpayer to maintain required documents or failure to submit the documents upon request by the tax authority will attract a penalty of up to 20% of the tax payable by the taxpayer under the tax law for the tax period to which the failure relates. If no tax is payable, the penalty shall be Birr 2,000 for each tax period the taxpayer fails to maintain the documents for the purpose of income tax.

Conclusion:

Transfer pricing represents an additional source of tax revenue for many governments globally, including the Government of Ethiopia. As a result, we anticipate increased inquiries and adjustments related to transfer pricing as the MoF enhances its capacity to audit multinational entities with operations in Ethiopia. It is also expected that specialised audit methodologies will be formulated for upcoming audits, focusing on both profitable sectors of the economy as well as sectors presenting significant transfer mispricing risks.

It is crucial for taxpayers to maintain adequate transfer pricing documentation on an annual (contemporaneous) basis that aligns with the controlled transactions occurring within and outside Ethiopia to ensure compliance and avoid penalties in the form of transfer pricing audit adjustments and other administrative penalties. With the increased volume and value of intra-group transactions, there is a risk of audit adjustments by the MoF and adequate transfer pricing documentation may mitigate such action.

Taxpayers should further explore and leverage the benefits of the APA program as a proactive measure to enhance tax compliance and mitigate potential transfer pricing issues. By engaging in an APA with the tax authority, businesses in Ethiopia can establish clarity and certainty regarding the acceptable criteria for determining arm's length prices for their related party transactions.

In conclusion, multinational entities operating in Ethiopia should undertake a thoughtful review of their existing transfer pricing arrangements. Embracing these new provisions presents an opportunity for companies to align their practices with evolving global standards, and will be essential in defending taxpayer positions during transfer pricing audits

KPMG is happy to assist on any issues arising from this alert. You can contact our tax and regulatory team for assistance on taxandregulatory@kpmg.co.ke

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