

# CHALLENGES OF APPLYING ETHIOPIAN VAT ON ELECTRONIC COMMERCE TRANSACTION

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## Abstract

Technology has impacted the incidence and manner in which taxation is imposed. The geographical foundations of existing taxing systems and non-territorial character of e-commerce is at heart of the challenge that e-commerce poses to taxation. The problems of buyer's identification, difficulty of establishing location/residence and status of party to e-commerce transactions are substantive challenges for Ethiopian VAT in the era of e-commerce. Similarly, the inadequacy of the Ethiopian VAT Proclamation to define what constitutes a 'permanent establishment' for e-commerce purposes, the absence of guidelines on acceptable records where goods are delivered, invoices issued and payments made by electronic means, lack of proper and adequate resources within the Tax Authority to monitor e-commerce transactions are identified as major challenges of applying Ethiopian VAT on e-commerce transactions. The article argues that a clear provision as to what constitutes a permanent establishment for e-commerce purposes should be recognised, and a special scheme which would require foreign vendors involved in supplying electronic services to Ethiopian consumer to register should be established. Further, for the sake of effective administration and collection of VAT revenue from e-commerce transactions, the cooperation of the Tax Authority with various stakeholders is advised.

Keywords: E-commerce, Taxation, Permanent Establishment, Transaction, VAT.

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## I. Introduction

Taxation is an integral part of human history. Historically the modern and organised collection of tax for kingdoms began with the emergence of great civilisation.<sup>1</sup> Tax is a compulsory financial levy imposed by governments upon its citizens in order to raise revenues to finance government spending on goods and services for the benefits of the society as whole.<sup>2</sup> Conventionally, countries imposed taxes on cross border transactions based on territorial jurisdiction. These are represented by source based taxation and residence based taxation to tax income<sup>3</sup>, and origin based and destination based principles to tax cross border supply of goods and delivery of services.<sup>4</sup> In source based taxation, the source country has jurisdiction to tax income sourced in its territory<sup>5</sup>, while in resident based taxation, the resident country has jurisdiction to tax its resident on their worldwide income.<sup>6</sup> Under origin based principle commodities are taxed in the exporting country and are tax exempt in the importing country<sup>7</sup>, while under destination principle commodities are tax exempt in exporting country and are taxed in place where they are consumed.<sup>8</sup>

Nowadays, the advancement in information and communications technologies (ICT) has ushered in a new means of communication known as the internet, which fundamentally impacts the way how human beings interact, starting from simple social interaction to complex multinational transactions. The shift from a physical oriented commercial environment to a technology driven electronic environment poses serious and substantial issues in relation to taxation and tax regimes.<sup>9</sup> As the existing tax regimes are mainly territorial and electronic commerce (e-commerce) is not, cross-border e-commerce is operating in a tax and tariff free environment, which if left unpremeditated, results in potential loss of tax and tariff revenues.<sup>10</sup>

Furthermore, e-commerce makes the traditional concepts of the permanent establishment (PE) rule, which is used to determine location of manufacture, point of sale for application of relevant tax rates and product classification for preferred tax rate difficult to apply. Therefore, the premise of the PE

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<sup>1</sup>Introduction and historical back ground of income tax in India, p.4., at: [http://shodhganga.inflibnet.ac.in/jspui/bitstream/10603/147895/9/09\\_chapter%20-i.pdf](http://shodhganga.inflibnet.ac.in/jspui/bitstream/10603/147895/9/09_chapter%20-i.pdf) (accessed on 9 February 2020).

<sup>2</sup> Richard Jones & Subhajit Basu, Taxation of Electronic Commerce: A Developing Problem, *International Review of Law Computers and Technology*, 2002 - 16 (1), pp.35-52, p. 35.

<sup>3</sup> Rifat Azam, Global Taxation of Cross-Border E-Commerce Income, *Virginia Tax Review* 2012 - 31(639), pp.639-693, p. 646.

<sup>4</sup> Marko Köthenbürger & Bernd Rahmann, 'Taxing Electronic Commerce', 9, at: <http://web.econ.ku.dk/koethenbuenger/EC.pdf> (accessed on 20 October 2020).

<sup>5</sup> Ibid.

<sup>6</sup> Ibid.

<sup>7</sup> Ibid.

<sup>8</sup> Ibid.

<sup>9</sup> Jones and Basu 2002, *supra note 2*, p.35.

<sup>10</sup> UNCTAD, TARIFFS, TAXES AND ELECTRONIC COMMERCE: REVENUE IMPLICATIONS FOR DEVELOPING COUNTRIES, 1 (2000), at: [http://unctad.ch/en/docs/itcdtab5\\_en.pdf](http://unctad.ch/en/docs/itcdtab5_en.pdf) (accessed on 23<sup>rd</sup> May 2020).

rule to conduct business in a given country with the need to presence does not easily apply to e-commerce transactions.<sup>11</sup>

The territorial character of the existing tax rules and non-territorial nature of e-commerce also creates differential treatment as between the traditional bricks and mortar<sup>12</sup> companies established through a PE and the dotcom companies conducting their businesses via cyber space. This is because the traditional bricks and mortar firm which have fixed place of business in a given country is obliged to pay tax and the dotcom firms which did not have fixed place of business can escape tax liability. This differential treatment violates major canons of taxation including the principles of tax neutrality and tax equity.<sup>13</sup>

E-commerce also challenges the conventional source and residence rules of determining income tax jurisdiction and origin and destination rules of determining consumption tax jurisdiction as the rules are strongly territorial and e-commerce is not.<sup>14</sup>

The article deals with the legal and practical challenges of applying Ethiopian Value added tax (VAT) to the e-commerce transactions. The first section of the article focuses on taxation and e-commerce in general. The second section focuses on general back ground under which the definition and nature of e-commerce are discussed. The third section is the major part of the work under which the development of e-commerce in Ethiopia and the law governing VAT in Ethiopia are discussed. The fourth section deals with the possible problems and challenges of applying Ethiopian VAT on e-commerce. The fifth and the final section of the work is the concluding part of the article.

## II. General Background

### II.1. Definition of E-commerce

The notion of e-commerce is a post 1990s development by which commerce is conducted electronically. There are many definitions of e-commerce. For instance, Black's Law Dictionary defines e-commerce as 'the practice of buying and selling goods and services through online consumer services on the internet'.<sup>15</sup> The Organisation for Economic Cooperation and Development (OECD) defined e-commerce as 'the sale or purchase of goods or services whether between businesses, households, individuals, governments, and other public or private Organisations

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<sup>11</sup> Rifat Azam, E-Commerce Taxation and Cyberspace Law: The Integrative Adaptation Model, 12(5) *Virginia Journals of Law & Technology* 2007, pp.1-34, p.9.

<sup>12</sup> Bricks and mortar refers to commercial entities with a physical (non-Internet) presence.

<sup>13</sup> David C. Powell, Internet Taxation and U.S. Intergovernmental Relations: From Quill to the Present', *Publius*, 30(1), 15, (The State of American Federalism, 1999-2000), at: <https://academic.oup.com/publius/issue-pdf/30/1/5366536> (accessed on 11 April 2020).

<sup>14</sup> Dale Pinto, 'E-Commerce and Source Based Income Taxation', 1 (IBFD publication, Amsterdam 2002), p.1, at: <https://espace.curtin.edu.au/bitstream/handle/20.500.11937/2653/131654131654.pdf?sequence=4&isAllowed=y> (accessed on 15 May 2020).

<sup>15</sup> Bryan A. Garner, *Black's Law Dictionary*, St. Paul, Minn: rev. West publishing 2009, 9<sup>th</sup> ed. P.589.

conducted over computer mediated networks'.<sup>16</sup> The United Nations Commission on International Trade Law (UNCITRAL) defines e-commerce as 'exchange of every kind of data message in the scope of commercial activities'.<sup>17</sup> The African Union Convention on cyber security and personal data protection has aptly defined e-commerce as 'the act of offering, buying or providing goods and services via computer systems and telecommunications networks such as the internet or any optical or similar media for distance information'.<sup>18</sup> Generally, e-commerce is simply defined as the process of buying and selling or exchange of products, services and information via computer network including the internet.<sup>19</sup>

## II.2. Nature of E-commerce

E-commerce may take different forms based on the parties involved in the transaction or by degree of digitalisation. Based on parties involved in the transaction e-commerce can be B2B (Business to Business), B2C (Business to consumer), C2C (Consumer to Consumer), B2E (Business to Employee), B2G (Business to Government) and sometimes G2C (Government to citizen).<sup>20</sup>

Based on degree of digitalisation, e-commerce is classified as pure (online) e-commerce and partial (offline) e-commerce.<sup>21</sup> Pure (direct) e-commerce is a form of e-commerce in which every activity starting from sale of product to payment and delivery are done online.<sup>22</sup> On the other hand, Partial (offline) e-commerce is a type of e-commerce which is characterised by the combination of traditional and pure e-commerce.<sup>23</sup> As a transaction needs some kind of physical requirement to deliver goods or services, either one of or both of the parties are physical.

## III. The Development of E-commerce in Ethiopia and the Law governing VAT

### III. 1. The Development of E-commerce in Ethiopia

Ethiopia is one of the least developed countries, which has recently experienced a tremendous growth in the number of internet users.<sup>24</sup> Different report shows, individual purchasers and

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<sup>16</sup> The OECD definition of internet and E-commerce transactions, Measuring the Information Economy, ANNEX 4, 89 (2002), p. 89.at: <https://www.oecd.org/internet/ieconomy/2771174.pdf>, (accessed on 27 December 2020).

<sup>17</sup> UNCITRAL, Model Law on Electronic Commerce, GA/Res/51/162, (30 January, 1997). Article1. at: <https://www.un.org/documents/ga/res/51/ares51-162.htm> (accessed on 20 March 2020).

<sup>18</sup> The African Union Convention on cyber security and personal data protection (n 3) Article1)

<sup>19</sup> Dr. P Ashokkumar, 'E-Commerce law and its legal Aspects', *International Journal of Law* 2018 - 4, pp.72-74.

<sup>20</sup> Michael Geist, 'A guide to global e-commerce law', at: <https://www.itu.int/ITU-T/specialprojects/ip-policy/final/Attach04.doc>, (accessed on 15 May 2020), p. 1.

<sup>21</sup> Orkhan Abdulkerim, 'Taxation of e-commerce', *Baku state University Law Review* 2015 - Vol.1, pp.98-107, p.101.

<sup>22</sup> Kenneth J. Hamner, Taxation of International and Domestic E-commerce: Inevitability, Structure, Problems and Solutions, 1 Fla. St. U. Bus. Rev. (2001), p.3.

<sup>23</sup> Ibid.

<sup>24</sup> Digital in 2017: 'Global Overview', at: <https://wearesocial.com/special-reports/digital-in-2017-global-overview> (accessed on 29 June 2020).

businesses buy more and more goods and services online both from local and foreign suppliers.<sup>25</sup> According to United Nation (UN) report of 2015, Business-to-Consumer (B2C) e-commerce sale in Ethiopia was 0.02 \$billions in 2009, 0.03 \$billions in 2010, 0.04 \$billions in 2011 and 0.06 \$billions in 2012.<sup>26</sup>

A report released by United Nation Conference on Trade and Development (UNCTAD) shows; dotcom firms operating e-commerce transaction in Ethiopia include Ethiogift.com, Genuine Leather Craft, Ethiolink, Ethiomerkato.com, Geezfont.com, Jomodesign.com, and Smoothassilk.com.<sup>27</sup> Among these Geezfont, smoothassilk and Jomodesign are the most common merchant model e-commerce that are engaged in direct e-commerce. There are also advertising model e-commerce, which include Delala.com, Kaymu.com, Qefira.com, Ebbisa.com, Sheger.net, Shebashopping.com, Ethiomarket.com, mercato.com and mekina.net. Attracted by untapped potential of the country, foreign based virtual service providers such as Kaymu and Junia Travel are also commencing their operation to bring the emerging trend to Ethiopia.<sup>28</sup>

A study conducted by Ministry of Communication and Information Technology (MCIT) revealed that in Ethiopia e-commerce generates \$60 million per year and with 31% annual growth rate. The figure put Ethiopia on top as compared to Kenya with 27% annual growth rate, South Africa with 20% and Egypt with 17%<sup>29</sup>, beside the absence of suitable ICT infrastructure and absence of legal environment governing e-commerce as compared to those countries.

### III.2. The Law Governing VAT

In Ethiopia, VAT applies as an indirect tax at different levels of production and distribution, which is ultimately paid by the consumers on classified consumer products. VAT is a consumption tax charged on both local sales and importation of taxable goods and services. In Ethiopia, introduction of VAT is among the major tax reforms of post 1990s. Thus, VAT was introduced in 2002 by replacing the sale tax.<sup>30</sup>

As VAT is a consumption tax charged on both local sales and importation of taxable goods and services, it constitutes the principal source of revenue for the Ethiopian government. The current VAT Proclamation No.285/2002 stipulates that VAT shall be charged in accordance with the

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<sup>25</sup> UNCTAD, 'E-commerce in the Least Developed Countries E-commerce and Development Report', New York and Geneva, 2001, Part Four, P. 192, at: <http://unctad.org/en/Docs/ecdr01p4.en.pdf> (accessed on 30 May 2020).

<sup>26</sup> UNCTAD, Information Economy Report 2015: Unlock the Potential of E-Commerce for Developing Countries, New York and Geneva, Sales No. E.15. II, D.1, 2015, P. 25, at: [http://unctad.org/en/Publications\\_Library/ier2015\\_en.pdf](http://unctad.org/en/Publications_Library/ier2015_en.pdf) (accessed on 11 October 2020).

<sup>27</sup> UNCTAD, 'E-COMMERCE AND DEVELOPMENT REPORT', Part Four, 204 (2001), at: [https://unctad.org/en/Docs/ecdr2001\\_en.pdf](https://unctad.org/en/Docs/ecdr2001_en.pdf) (accessed on 27 July 2020).

<sup>28</sup> Eden Sahle, 'E-commerce paving its way in the Untapped Ethiopian Market', at: <https://travel.junia.com/blog/hotels-ethiopia-gearing-towards-growth-going-digital-2-4929> (accessed on 8 July 2020).

<sup>29</sup> Development of Ethiopian National E-commerce Deployment Platform and Implementation Strategy, Situational Report MCIT, 2016, P.80.

<sup>30</sup> Wollela Abehodie, 'Value Added Tax Administration in Ethiopia', *e Journal of Tax Research* 2008-6(2), pp.145-168, p.145, at: [https://www.business.unsw.edu.au/research-site/publications-site/ejournaloftaxresearch-site/Documents/paper4\\_v6n2.pdf](https://www.business.unsw.edu.au/research-site/publications-site/ejournaloftaxresearch-site/Documents/paper4_v6n2.pdf) (accessed on 15 December 2020).

provisions of the Proclamation on the supply of goods and services in Ethiopia and on the importation of goods and services into Ethiopia. Correspondingly, the Proclamation applies to the supply of goods and rendering of services conducted by a non-resident in Ethiopia through a permanent establishment in Ethiopia or through the internet.<sup>31</sup> Therefore, as per Article 4(7) of the VAT Proclamation, if a non-resident engaged in the supply of goods and rendering of services via internet then the VAT Proclamation will be applied. This is also true when there is no physical presence in the jurisdiction.

### **III.2.1. Taxable Transactions under Ethiopian VAT**

A taxable transaction is defined in the VAT Proclamation expansively as ‘[a] supply of goods or a rendition of services in Ethiopia in the course or furtherance of a taxable activity other than an exempt supply’ under Article 8.<sup>32</sup> Here, the VAT Proclamation of Ethiopia specifies that VAT shall be charged on any supply of goods or services in Ethiopia where it is a taxable supply made by a taxable person in the course of or in furtherance of any business carried out by him or her. There are, however, lists of exempted goods and services from VAT by the Proclamation. In this sense, it can be stated that the notion of taxable transaction is related to the supply of goods or rendition of services.

When referring to the VAT Proclamation for the definition of goods and services, the term ‘good’ is defined broadly. It includes all corporeal movable or immovable property.<sup>33</sup> The definition is confined to corporeal property. Hence, incorporeal property such as intellectual property and other intangible properties are not considered as goods.<sup>34</sup> However, incorporeal property may be treated as services for the purposes of VAT. The definition expressly includes thermal or electrical energy, heat, gas, refrigeration, air conditioning and water. Thus, the transfer or provision of these utilities is treated as a supply of goods (not services) for the purposes of the VAT.

The other term that is central to the operation of the VAT is ‘service’. As provided under Article 2(16), services are defined as ‘work done for others which does not result in the transfer of goods’. This catchall definition has a vital role in preventing sales from escaping tax by not falling within either the definition of goods or services. What we have to understand here is that the terms ‘goods’ and ‘services’ shall be treated separately and something cannot be goods and services at the same time.<sup>35</sup>

With respect to the classification of digitised items, the VAT Proclamation does not contain a specific provision that determines how digitised items will be characterised as either goods or services. Nonetheless, the definition of services is broadly formulated and includes everything that does not constitute goods. Accordingly, the supply of digital content or electronic services would most likely be classified as a service. It follows that intangible property does not constitute goods and

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<sup>31</sup> Value Added Tax Proclamation, 2002, Federal Negarit Gazeta, Proc. No. 285/2002, 8<sup>th</sup> year, No. 33, [here after VAT Proclamation] Art. 4(7).

<sup>32</sup> *Idem*, Art.8.

<sup>33</sup> *Idem*, Art.2 (7).

<sup>34</sup> Art. 2(7) define “goods” as, “all kind of corporeal movable or immovable property, thermal or electric energy, heat, gas, refrigeration, air conditioning and water energy, but does not include money.

<sup>35</sup> Yohannes Mesfin. & Sisay Bogale., Tax Law Teaching Material, Prepared Under the Sponsorship of the Justice and Legal System Research Institute, 2009, p.73.

therefore falls within the definition of services.<sup>36</sup> This corresponds to an EU proposal that, for VAT purposes trade in digital goods may be treated as a supply of services.<sup>37</sup> Here the VAT Proclamation of Ethiopia says nothing as to what electronically supplied services includes. For instance, in South Africa the VAT Regulation lists the services that meet the definition of electronic services per the VAT Act. Consequently, educational services, games and games of chance, internet-based auction services, miscellaneous services and subscription services are electronic services where such services are supplied by means of any electronic agent, electronic communication or the internet for any consideration.<sup>38</sup> Yet in Ethiopia, there is no legislative definition of electronically supplied services for VAT purposes. Thus, to clear up some misunderstanding concerning what is included in the definition of electronic services it is necessary that the law should be clarified.

For practical purposes a distinction must also be drawn between supplies that are ordered and delivered on the internet by electronic means, and commodities that are ordered on the internet and delivered by traditional means.<sup>39</sup> In the latter case, administrative procedures already in place for traditional cross-border trade continue to apply.<sup>40</sup>

The supply of tangible goods ordered over the internet is relatively easy to monitor because tangible corporeal goods must be cleared through customs at a border post before entering the country.<sup>41</sup> Goods delivered by airmail are monitored by the Ethiopian post office where the value for VAT purposes is determined, and where VAT is levied at the appropriate rate.<sup>42</sup> These goods, accompanied by a VAT declaration are posted to the recipient. The recipient must pay VAT (as indicated on the VAT declaration form) at the post office where the package is collected. The fact that tangible goods, which are ordered electronically, are delivered to a designated physical address simplifies the task of ensuring that appropriate VAT is levied and collected.<sup>43</sup>

In the case of internet deliveries of incorporeal items such as software, music, and videos it is often difficult to determine whether or not a transaction has occurred.<sup>44</sup> Since electronic deliveries do not go through the mails or customs it is difficult to track and trace the occurrence of these transactions.<sup>45</sup> Meaning, in electronically delivered digitised products delivery cannot be intercepted as in the case of corporeal goods that must enter a customs area, which would essentially avoid import VAT.

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<sup>36</sup> Gregory Johnston, 'Value Added Tax on Virtual World Transaction: A South Africa Perspective', *International Business and Economics Research Journal* 2013-12(1), pp.71-78, P. 76.

<sup>37</sup> Jones & Basu 2002, supra note 2, p. 35.

<sup>38</sup> South African Value-Added Tax Act, 1999, Regulations Prescribing Services for the purpose of the definition of "Electronic Services", Government Gazette, Act No. 89/1999, No. 37489, Section 1. The Regulation is similar to that of the European Union (EU) per Annexure 1 to the council Regulation of 17 October 2005.

<sup>39</sup> Liam Ebrill, et al. 'The Modern VAT, International Monetary Fund, Washington', D.C. 2001, P. 186.

<sup>40</sup> OECD, 'International VAT/GST Guidelines on Neutrality', 2011, P.5, at: <http://www.oecd.org/tax/consumptiontax/48331948.pdf> (accessed on 11 October 2020).

<sup>41</sup> Theo Steyn, 'VAT and E-commerce: Still Looking for Answers?', *SA Mercantile Law Journal* 2010-22(2), pp. 230- 258, p. 233.

<sup>42</sup> Ibid.

<sup>43</sup> Idem, p. 234.

<sup>44</sup> Liam Ebrill L, et al, 2001, supra note 39, p.187.

<sup>45</sup> Idem, p. 5.

### III.2.2. Taxable Activity under Ethiopian VAT

Article 6 of the VAT Proclamation envisages what kind of activity or transaction is subject to imposition of VAT. Accordingly, Taxable activity is '[A] n activity which is carried on continuously or regularly by any person (1) in Ethiopia or (2) partly in Ethiopia whether or not for pecuniary benefit that involves or is intended to involve in whole or in part, the supply of goods or services to another person for consideration'.<sup>46</sup>

Based on the above definition, irrespective of the profit accrued, insofar as there is regular or continuous supply for consideration it is considered as a taxable activity. In other words, an activity may be a taxable activity within paragraph (2), whether or not it is carried on for pecuniary profit. The terms regularly and continuously here indicate the frequency of the transaction. Hence, an activity carried on continuously or regularly by any person wholly or partly in Ethiopia that involves or is intended to involve the supply of taxable goods or services to a person for consideration is a taxable activity. However, as per the Value Added Tax (Amendment) Proclamation, the phrase 'any person' under Article 6 is replaced by 'any registered person'.<sup>47</sup> Similarly, the requirement of 'activity which is carried on continuously or regularly' is also changed to 'activity whether or not carried on continuously or regularly'.<sup>48</sup> Hence, to be taxable, the activity does not have to be carried on continuously or regularly. Meaning, as far as the activity is carried out by a registered person, it is taxable (assuming the other necessary conditions are met).

When looking at taxable activities regarding e-commerce transactions, businesses can advertise and sell products through their own websites and cyber malls. Other examples of taxable activities would be delivering the product via internet, courier services and information databases that can be subscribed to at a fee.<sup>49</sup> Delala.com, Mercato.com and Qefira, are examples of online and mobile web based advertisement platforms that sells advertising space to advertisers by letting them promote and market their products and reach their target audiences. Similarly, Jumia sells various used and new products including clothes, shoes, accessories, mobiles, jewelries and other similar products to buyers.<sup>50</sup>

Another potential taxable activity in e-commerce transaction is the sale of intangible property such as software and related purchases. Where those and similar e-commerce activities are carried on by any registered person either in Ethiopia or partly in Ethiopia, then the activity is subject to VAT. This is true whether the activity is being carried on continuously or regularly.

Another important point that must be borne in mind is that, in the Ethiopian VAT proclamation, the place of supply is included in the definition of taxable activity, as the taxable activity must be

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<sup>46</sup> VAT Proclamation 2002, supra note 31, Art. 6.

<sup>47</sup> Value Added Tax (Amendment) Proclamation, 2008, Federal Negarit Gazeta, Proc. No. 609/2008, 15<sup>th</sup> year, No.6, Art. 2(3).

<sup>48</sup> Ibid.

<sup>49</sup> Sijbren Cnossen., 'VAT Treatment of Immovable Property', Tax Law Design and Drafting, 1996, No. 1, P. 421.

<sup>50</sup> Ibid.

conducted in Ethiopia or partly in Ethiopia.<sup>51</sup> It is, however, not clear when e-commerce transactions are considered to be conducted in Ethiopia as yet no guidelines are issued in this regard.

### III.2.3. The VAT Rate

Ethiopia has two VAT rates upon which tax is calculated: the standard rate of 15%, and zero-rate, both of which are computed on taxable supplies.<sup>52</sup> The standard rate of 15% is payable upon importation of goods and services irrespective of whether the importer is a VAT registered taxpayer or not.<sup>53</sup> Conversely, the supply of goods that are exported is zero-rated. Likewise, services rendered outside Ethiopia and services rendered to a non-resident who is outside Ethiopia are zero-rated. However, regarding e-commerce it is not clear what will constitute proof where these services are delivered over internet and apply the applicable VAT rate provided in the Proclamation.

### III.3. Regulation of VAT on E-commerce under the Current VAT System

Another important point which should be noted at this stage relates to the notion of tax collection mechanisms. This is important because inadequate and inappropriate VAT collection mechanisms in cross-border e-commerce transactions are the main sources of VAT fraud and the erosion of the tax base.<sup>54</sup> As far as online consumption taxes are concerned, there are various approaches. These approaches include: self-assessment/reverse charge, registration of non-residents, tax at source and transfer, collection by trusted third parties, and Technology based solutions.<sup>55</sup> Under self-assessment or reverse charge systems, recipients would be required to determine a tax on imports of services and intangible property, and to remit this amount to the domestic Tax Authority.<sup>56</sup> This system is currently in place in most OECD member countries and in Ethiopia as well. Especially, where the transaction is B2B and the recipient business is a registered VAT person in the country of consumption, self-assessment approach has proven feasible and effective. Moreover, it carries a low compliance and administrative burden.<sup>57</sup> This is because tax authorities can verify and enforce compliance without difficulty.

In terms of the registration system, non-resident businesses are obliged to register in a jurisdiction and to charge, collect and remit the consumption tax to a country of registration.<sup>58</sup> This approach is deemed to be feasible, effective and promotes tax neutrality.<sup>59</sup> The effectiveness of a registration

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<sup>51</sup> VAT Proclamation 2002, supra note 31 Art. 10(1), in tandem with Art. 6.

<sup>52</sup> Idem, Art. 7(1) (2).

<sup>53</sup> However, unlike individual consumer, VAT registered importers are entitled to claim credit for VAT paid on imports in their monthly VAT returns.

<sup>54</sup> Alfredo J., 'Applying VAT to International Trade-The Challenge of Economic Globalization: The Challenge for Tax Administrations, First Meeting of the OECD Global Forum on VAT', 2012, P. 54, at: <http://www.oecd.org/ctp/consumptiontax/PptpresentationsessionmaterialGFonVAT.pdf> (accessed on 6 April 2020).

<sup>55</sup> Andreas K. VAT Taxation of E-Commerce -Under Special Consideration of the 6<sup>th</sup> EU VAT Directive-, (Unpublished, LL.M Dissertation, University of Cape Town). P.6.

<sup>56</sup> Ibid.

<sup>57</sup> Emerging Concepts for Defining Place of Consumption, P. 4, at: <http://www.oecd.org/tax/consumptiontax/39874228.pdf> (accessed on 12 April 2020).

<sup>58</sup> OECD, International VAT/GST Guidelines, 2006, P. 10, available at: <http://www.oecd.org/ctp/consumptiontax/36177871.pdf> (accessed on 16 March 2020).

<sup>59</sup> Andreas K, supra note 55.

system is, however, greatly affected by registration and other hidden costs, difficulties in identifying the suppliers, and enforcing the obligation of registration on non-suppliers.<sup>60</sup> Rather than registering in each jurisdiction where supplies are made, there is another option in which the suppliers are taxed at source country and transfer the revenue to the jurisdiction of consumption.<sup>61</sup> However, this alternative is considered to be unfeasible in the near future<sup>62</sup>, because, in addition to the increase cost of administration, an international agreement regarding enforcement, collection and revenue transfers is required.<sup>63</sup>

The collection of consumption taxes by third parties is also another approach. In this method, the responsibility of collecting taxes is not with the revenue authorities, rather financial institutions might have to bear that task.<sup>64</sup> This system could be effective. Nonetheless, as the issue of trustworthiness is subjective, the feasibility of shifting the onus of collection onto trusted third parties is questionable.<sup>65</sup>

Lastly, inventing a new technology that simplifies the tax collection system might be another feasible approach. This method of tax collection involves the use of software, which would automatically calculate the tax due on a transaction and remit (through a financial intermediary) the tax to the jurisdiction of consumption.<sup>66</sup> However, this might not be realized in a short term, rather a medium to long term option<sup>67</sup> as different jurisdictions have different level of economic development.

### **III.3.1. Registration for VAT**

At the outset, it is worth noting that registration is one of the basic elements of VAT. The VAT Proclamation of Ethiopia provides for both mandatory and voluntary registration of tax payers. Thus, persons are required to register as a taxpayer if they make or anticipate to make taxable supplies with a total value that exceeds the stipulated threshold value five hundred thousand (500,000) Ethiopian birr for a twelve month period.<sup>68</sup> Meaning, as per the VAT Proclamation, if the total value exceeds 500,000 birr, registration is compulsory. When the threshold has been reached, the person liable to be registered as a taxpayer is required to take the necessary steps to apply for registration within the time frame specified under Article 16(3) of the VAT Proclamation.

Registration may occur voluntarily, provided that the applicant person shall supply goods or render services at least 75% of his/her goods and services to a person registered for VAT in a regular manner.<sup>69</sup> A direct consequence of voluntary registration is that the registered person will have to

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<sup>60</sup> OECD, Consumption Tax Aspects of Electronic Commerce, A report from Working Party No. 9, 2001, P. 15, at: <http://www.oecd.org/tax/consumption/2673667.pdf> (Accessed on 15 April 2020).

<sup>61</sup> Ibid.

<sup>62</sup> Idem, p. 16.

<sup>63</sup> Ibid.

<sup>64</sup> Ibid.

<sup>65</sup> Ibid.

<sup>66</sup> Ibid.

<sup>67</sup> Andreas K supra note 55, P. 23.

<sup>68</sup> VAT Proclamation 2002; supra note 31, Art.16(1).

<sup>69</sup> Idem, Art.17.

account for output tax and will be able to claim credit or refund,<sup>70</sup> as an agent of Ethiopian Custom and Revenue Authority (ERCA).

In practice, though online transactions have become one of the growing commerce models in Ethiopia, there is little exercise in which stores on e-commerce websites are registered or report their incomes to the tax authority. An interview with the e-commerce website representatives on the question of whether they are registered for VAT or not reveals that, out of the 5 e-commerce websites, 3(60%) of them are registered for VAT and 2(40%) of them are not registered for VAT. The main reasons why those e-commerce websites are reluctant for registration is lack of awareness about the time, ways and reasons of registering for VAT, the absence of strong control by the authority, the need of society to buy goods and services without VAT. Likewise, the tax authority does not device an effective online system for the registration of e-commerce websites for VAT purpose. These pitfalls in the existing tax system results in the reduction of potential tax revenues.

### **III.3.2. Reverse Charge Mechanism and Its Application to E-commerce**

Under the reverse charge mechanism, the person liable for the payment of the VAT on the particular transaction is the recipient/ buyer.<sup>71</sup> In other words, in this mechanism the liability to pay VAT is shifted from the seller to the buyer. The supplier/service provider would be solely responsible for indicating the transaction to the Revenue service.<sup>72</sup> The following discussion is devoted to discuss the reverse tax rules of Ethiopia and its application in B2B and B2C e-commerce transactions.

#### **a) The application of reverse charge mechanism to B2B e-commerce in Ethiopia**

When we see the case of reverse charge mechanism in the Ethiopian context, the VAT Proclamation provides that if a non-resident person who is not registered for VAT in Ethiopia renders services in Ethiopia for a person registered in Ethiopia for VAT or any legal person, the rendering service is subject to taxation.<sup>73</sup> Therefore, in the case of B2B e-commerce transactions for purposes other than exempted supplies, the recipients of electronic services, the imported service are required to make use of the reverse-charge mechanism.<sup>74</sup> As provided under Article 23(3) of the VAT Proclamation, the amount of tax imposed is dictated by a method of calculation to be determined by Regulations issued by the Council of Ministers. Consequently, if a consumer who is registered for VAT receives the imported service, he/she is required to pay VAT at the time for filing of the VAT return for the accounting period in which the transaction took place.<sup>75</sup> Nonetheless, where the customer is not registered for VAT, the period of payment is different and the withheld tax is payable within 30 days of payment to the non-resident.<sup>76</sup> It must be noted that a person who receives imported services still has to acknowledge receipt of the non-taxed imported service to ERCA and later declare it as input

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<sup>70</sup> Mesfin. & Bogale, supra note 35, P. 75; see also VAT Proclamation 2002, supra note 31, Art. 27.

<sup>71</sup> International VAT Association, Combating Fraud in the EU: *The Way Forward*, Report Presented to the European Commission, 2007. P. 22, at: <http://www.accountingnet.ie/artman2/uploads/iva-paper-final.pdf>.(accessed on 23<sup>rd</sup> October 2020).

<sup>72</sup> Ibid.

<sup>73</sup> VAT Proclamation 2002, supra note 31, Art. 23(1) and (2).

<sup>74</sup> Idem, Art.23(3) and Art. 3(7).

<sup>75</sup> Idem., Art. 23(4).

<sup>76</sup> Idem., Art. 23(5).

tax. Accordingly, if a business person does not issue receipts then it cannot claim a refund of the corresponding amount on taxes it paid on inputs it purchased.

Generally, the reverse charge mechanism adopted by the government of Ethiopia has a number of key advantages. Firstly, the Ethiopian Tax Authority can verify and enforce compliance since that authority has jurisdiction over the customer. Secondly, the compliance burden is shifted from the supplier to the customer and is minimized since the customer has full access to the details of the supply. Thirdly, the compliance costs for the Tax Authority are also low because the supplier is not required to meet tax obligations in Ethiopia (e.g. VAT identification, audits, which would otherwise have to be administered). Finally, it reduces the revenue risks associated with the collection of tax by non-resident suppliers, whether that supplier's customers are entitled to deduct the tax or recover it through input tax credits. However, it is worth noting that in Ethiopia there is no effective online payment system currently working on the international level.<sup>77</sup> The most common means of payment used for import trades are Letter of Credit, Cash against document and other similar trade instruments.<sup>78</sup>

Similarly, many of the importers in Ethiopia are dependent on Letter of Credit and 77% of the importers use Cash against Document as a means of payment.<sup>79</sup> But, this payment system is traditional, compared to the new e-commerce payment system like credit card and debit card. In Ethiopia, the reality shows that the infrastructure for the latter two payment modalities for foreign trade payment is almost not exist.<sup>80</sup>

Further, it is illegal for individuals to casually trade on foreign exchange. Those foreign exchange restrictions on payments and transfers are not consistent with international standards, as determined by the International Monetary Fund (IMF).<sup>81</sup> For example, the Ethiopian currency (birr) is not freely convertible because the exchange rates are set by the government.<sup>82</sup> Similarly, Ethiopia limits foreign currency inflows, outflows, and the amounts that local and foreign individuals and companies can hold.<sup>83</sup> These restrictions have a negative impact on the growth of those e-commerce ventures currently operating and turning away possible foreign investment in new initiatives.<sup>84</sup> Similarly; it increases money laundering and underground market in Ethiopia when individuals and businesses seeking to operate internationally need to find alternative means of managing their foreign exchange

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<sup>77</sup> Belaynew Asrie., *Electronic Commerce: Opportunities and Challenges of general importers in Addis Ababa*, (Unpublished, MBA Thesis, Addis Ababa University, June 2012. P.69. at: <http://213.55.95.56/bitstream/handle/123456789/13275/Belaynew%20Asrie.pdf?sequence=1&isAllowed=y>(accessed on 21<sup>st</sup> November 2020).

<sup>78</sup> Ibid.

<sup>79</sup> Ibid.

<sup>80</sup> Belaynew Asrie 2012, supra note 77, p.69.

<sup>81</sup> IMF, "The Federal Democratic Republic of Ethiopia: 2013 Article IV Consultation," IMF Country Report, No. 13/308, October 2013, P. 27, at: <https://www.imf.org/en/Publications/CR/Issues/2016/12/31/The-Federal-Democratic-Republic-of-Ethiopia-2013-Article-IV-Consultation-40991> (accessed on 15 June 2020).

<sup>82</sup> National Bank of Ethiopia, "Foreign Exchange Directives", at: <http://www.nbe.gov.et/pdf/Consolidated%20Forex.pdf> (accessed on 16 June 2020).

<sup>83</sup> Ibid.

<sup>84</sup> Interview with Teninet Yibeltie, Customer Service officer at Commercial Bank of Ethiopia, on e-commerce transactions, July 6, 2019.

needs. These alternative means are difficult for the authority to monitor and track.<sup>85</sup> At a more individual level, due to these foreign exchange restriction problems, taxpayers will not report the details of transactions that are carried out electronically to the authority; this ultimately limits the ability of the government to collect VAT from those transactions.

### **b) The application of reverse charge mechanism to B2C e-commerce in Ethiopia**

The method of collection under the cross-national e-commerce transaction is in large part dependent upon whether a transaction involves the delivery of a good or of a service. When, for example, a final consumer orders a taxable tangible goods (i.e. DVD, CD, clothing, etc.) over the internet, but the good is physically shipped to the consumer in Ethiopia, this is considered "indirect e-commerce," and the rules governing the collection of VAT is similar to that of goods ordered by traditional means.

Here, the VAT Proclamation of Ethiopian under Article 23(1) (2), without any distinctions of the types of the transaction, extends the application of reverse charge mechanism on B2C e-commerce transactions. However, reverse-mechanism suits well for B2B transactions, when business customer self-assesses VAT; the application of self-declaration to B2C transactions is connected with some complexities of enforcement.<sup>86</sup> This is because, firstly, since reverse-mechanism is reliant mostly on the honesty of the recipient, private customers (legal person) probably have stronger incentive to avoid tax collection than business customers.<sup>87</sup> Especially, when a consumer purchases a good or service over the internet and accepts electronic delivery of that good or service by downloading it onto his personal Computer, it does not go through mails or customs, as a result essentially avoid import VAT.<sup>88</sup>

The situation is further exacerbated by the fact that, the Tax Authority of Ethiopia does not have effective mechanism to detect and control supplies of electronically supplied services; hence, customers' tax avoidance will substantially increase.<sup>89</sup> Secondly, the VAT Proclamation provides, by adducing the invoices, an incentive for businesses to compute input VAT credit for their purchases or expenses. Nonetheless, the incentive is not present in purchases by final consumers as the latter generally do not have the option to deduct their expenses for tax purposes or claim input VAT credit. Moreover, while businesses are better aware of tax obligations and often have educated manpower for carrying out tax tasks, some customers stay ignorant in this respect.<sup>90</sup> This has the effect that Ethiopian consumers can buy imported digital goods or services without paying VAT. Thus, despite the advantages of simplicity in realization, for B2C e-commerce private customers'

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<sup>85</sup> Interview with Tesfu Techane, Investigation Team Coordinator at ERCA, on e-commerce taxation; July 1, 2019.

<sup>86</sup> OECD, Report by the Technology Technical Advisory Group (TAG), 2000, P. 52, at: <http://www.oecd.org/dataoecd/46/2/1923248.pdf> (accessed on 28 April 2020).

<sup>87</sup> Interview with Endalelign Asrat, Tax Payers Education and Support Team Coordinator at ERCA, on e-commerce taxation, July 1, 2019.

<sup>88</sup> Interview with Getachew Dilu, Law Enforcement Process Coordinator of ERCA, on the enforceability of Ethiopian VAT law on e-commerce, July 1, 2019.

<sup>89</sup> Interview with Tesfu Techane, supra note 85. There is also no existing process to accurately verify ownership or the location of the beneficial owner of the website. Therefore, the potential for tax evasion through e-commerce in Ethiopia is very high.

<sup>90</sup> Interview with Endalelign Asrat, supra note 87.

self-assessment mechanism is not recommended as the reliable method of tax collection neither by the EU, nor by the OECD as well.

When looking at the current practice, it may be seen that the main problem against an effective VAT system for international e-commerce transactions in Ethiopia is the lack of attention to the taxation of e-commerce transactions as a unique concept and the lack of unique policies to regulate the sector.<sup>91</sup> From questions posed to the ERCA officers, it emerged that there is lack of proper and adequate resources, specialized human resource and institutional setup within the Tax Authority to monitor the taxation of e-commerce.<sup>92</sup> The problem for enforcement in e-commerce taxation were also raised due to the absence of tough integrated efforts of ERCA with the major stakeholders such as Information Network Security Agency (INSA), Ethio-telecom and Banks in tracing the requisite e-commerce transactions. Consequently, regarding the practical side of the problematic VAT issues; the study established that theoretical soundness of the prospective proposals would not in itself suffice for the implementation thereof. Given that electronic commercial activity has been evolving with the development of technology, its regulation and implementation should also be technology based.

### **III.3.3. The VAT Invoice**

The invoice is the crucial control document of the usual VAT system.<sup>93</sup> It helps the Tax Authorities to establish the tax liability of the supplier and the entitlement of the purchaser to a deduction for the VAT charged.<sup>94</sup> Invoices must be carefully completed and kept as records. In Ethiopia, the VAT Proclamation under Article 22(1) specifies that people registered for VAT are required to issues a VAT invoices for taxable transactions unlike the people who aren't registered for VAT.<sup>95</sup> Hence, each VAT registered e-commerce business is required to retain their copy of the invoice at their offices to be inspected by a VAT auditor. But, practically contrary to VAT Proclamation, as (7) 46.6% of the e-commerce customer's respondents declare e-commerce websites do not issue a tax invoice; whereas, (8) 53.4% of the respondents replied that, "during their transaction VAT invoices are issued by e-commerce websites".

On this basis, it could be argued that in practice some of the e-commerce websites do not comply with the laws and regulations of the VAT Proclamation. This is since a number of e-commerce websites in Ethiopia do not issue VAT invoices for all taxable e-commerce transactions. As a result, the tax collected by taxpayers is not paid to the Tax Authority which in turn results in tax revenue loss.<sup>96</sup> The situation is further aggravated by the fact that the Tax Authority is incapable of identifying and controlling e-commerce business that are not in compliance with the VAT laws. On the other hand, an electronic invoice system that could form the basis of claiming an input tax credit for VAT

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<sup>91</sup> Interview with Tesfu Techane, supra note 85.

<sup>92</sup> Interview with Endalelign Asrat, supra note 87, Interview with Getachew Dilu, supra note 88.

<sup>93</sup> Alan Tait., Value Added Tax: Administrative and Policy Issues, International Monetary Fund, Washington, D.C.1991, P. 279.

<sup>94</sup> Ibid.

<sup>95</sup> VAT Proclamation 2002, supra note 31, Art. 22(1).

<sup>96</sup> But, it is good to note that the actual revenue losses associated with e-commerce transactions are difficult to estimate as there are currently no empirical studies that attempt to measure these losses.

paid in e-commerce transaction are not indorsed in Ethiopia. Thus hindering the opportunities for businesses to reduce the costs of transactions conducted via internet.<sup>97</sup>

### **III.3.4. Non-Compliance with the VAT Proclamation**

As per Articles 45 and 46 of the VAT Proclamation failure to register, issue a tax invoice, maintain recorder and failure to file timely return shall result in administrative penalties ranging from a fine 100 percent of the amount of tax payable and a fine of up to 50,000 Birr.

Apart from administrative penalties, tax offences such as tax evasion, making false or misleading statement and failure to notify are criminalised under Ethiopian law. Accordingly, tax fraud, making false or misleading statements is punishable with a fine ranging from 1000 Birr to 100,000 Birr and imprisonment ranging from 3 years to 5 years. Where the making of false or misleading statement is made intentionally or recklessly such offence is punishable by a fine of up to 200,000 Birr and imprisonment of up to 15 years.<sup>98</sup>

Taking into account the above laws, in practice measures taken by the ERCA to control and punish e-commerce business for their non-compliance is minimal. Some of the reasons for taxpayer's compliance problems includes: less attention given to taxation of e-commerce; the absence of strong controlling system against fraud and evasion carried out by non-compliance e-commerce websites; the deliberate evasion and unlawfulness of e-commerce websites.<sup>99</sup>

## **IV. The Possible Problems and Challenges in the Application of Ethiopian VAT on E-commerce Transactions.**

The above discussion demonstrated the applicability of the current VAT systems on e-commerce transaction in Ethiopia. Nonetheless, it is important to note that applying VAT on e-commerce transactions is not without any flaws. In the following section, the possible challenges posed by taxation of VAT on e-commerce under the Ethiopian VAT system will be analyzed. This analysis indicates what problems and challenges should be considered when adjusting the current VAT system in the context of e-commerce within Ethiopia.

### **IV.1. Verifying the Details of a Transaction**

Unlike the traditional ways of commerce, e-commerce transactions have more anonymous character because they can be carried out without papers, pens, offices, warehouses, and even without employees. In such environment, Tax Authorities may not easily verify the products and services delivered and other details of a transaction concluded over the internet.<sup>100</sup> This can create favorable

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<sup>97</sup> Interview with Fisha Assefa, General Manager of Mercato.com, on the application of Ethiopian VAT law to ecommerce transactions, November 23, 2019.

<sup>98</sup> VAT proclamation 2002, supra note 31, section 12.

<sup>99</sup> Interview with Endalelign Asrat, supra note 87; Interview with Getachew Dilu, supra note 88.

<sup>100</sup> Ertuğrul Akçaoglu ., 'International Taxation of Electronic Commerce: A Focus on the Permanent Establishment Concept', 2002, pp.117-157, P. 127, at: <http://dergiler.ankara.edu.tr/dergiler/38/287/2615.pdf> (accessed on 26 April 2020).

condition for the customers to alter or change the documentation in such a way to pay minimum VAT to the authorities.

Besides, e-commerce leaves less of a paper trail as compared to invoices and receipts, which tax authorities often use to track down and verify conventional transactions. Moreover, even when electronic records are available, they are subject to tampering to a greater extent than paper records are.<sup>101</sup> Therefore, e-commerce might pose a challenge for the Ethiopian Tax Authorities to verify the details of the transactions and this could lead to tax loss for the Government.

#### **IV. 2. Identifying the Parties to a Transaction**

It is important to identify the parties to a transaction to determine the relevant tax authorities and the applicable tax legislation. Nevertheless, one of the key attributes of online transactions is that the identification of the consumer is not easily ascertainable. The decentralised and global aspect of the internet makes it difficult to discover the identity or geographic location of economic participants, especially in the B2C type of e-commerce.<sup>102</sup> The anonymous nature of the network, hence, allows tax payers to leave little evidence of their participation in economic activity and frustrate attempts by Tax Authorities to track and audit taxpayers.

In Ethiopia, neither the VAT Proclamation nor its regulation cover how the supplier or the tax authority is supposed to determine the residence of the consumers, which is necessary for the application of the VAT rules. This problem is more aggravated, mostly because, the parties' aspiration to provide false details for the transactions that makes the identification of the details of the transaction and parties by the Tax Authority more difficult.<sup>103</sup> In this regard, the Australian Tax Authority adopted a registration system whereby internet businesses would have to register their online address (i.e. their Internet Protocol (IP)) address) as well as the physical location for their main office.<sup>104</sup> Similarly, the OECD made substantial findings in this field. Specifically, it is considered consumer self-declaration, credit card billing address, IP traces and digital certificates as possible methods to identify the buyer in an e-commerce transaction.<sup>105</sup>

#### **IV.3. Permanent Establishment**

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<sup>101</sup> National Electronic Commerce Coordinating Council (NECCC) , Challenges in Managing Records in the 21<sup>st</sup> Century, 2004, P. 9-13, at: <http://pearcmoses.info/papers/challenges-in-El-Records.pdf> (accessed on 15<sup>th</sup> October 2020).

<sup>102</sup> Arthur J. Cockfield., 'Balancing National Interests in the Taxation of Electronic Commerce Business Profits', *Tulane Law Review*,1999-74, pp,133-217.

<sup>103</sup> Interview with Birhanu Nigussie, officer of ERCA, on the identification of the details of e-commerce transaction, May 9, 2019; unfortunately, even if the VAT Proclamation offered acceptable sanctions, practical implementation thereof would still be impossible. Namely, the Tax Authorities, in order to enforce VAT laws, need to identify the infringing persons. In practice, there are circumstances where the online platform acts as a trading platform rather than a trader. In this case the online platform's clients are various sellers who own the inventory of goods and advertise their goods on the online platform. However, the ultimate sale of the goods is completed between the third party seller and the end consumer.

<sup>104</sup> Australian Tax Office, Tax and The Internet, Discussion Report of the ATO Electronic Commerce Project, 1997, at: [http://downloads.ato.gov.au/content/business/downloads/ECOM\\_P1.rtf](http://downloads.ato.gov.au/content/business/downloads/ECOM_P1.rtf) (accessed on 24 March 2020).

<sup>105</sup> OECD 2000, supra note 86, P. 5-7.

Another arising issue concerns the taxation of e-commerce in Ethiopia is the notion of permanent establishment (PE). As noted above, to be taxable in a specific jurisdiction, certain connecting factors need to be present. Accordingly, the VAT Proclamation provides that the supply of goods and rendering of services is taxable if it is carried out by a non-resident through a permanent establishment in Ethiopia or through the internet.<sup>106</sup>

Article 2(10) of the VAT Proclamation defines permanent establishment as a “fixed place of business through which the business of an enterprise is wholly or partly carried on”. The following shall, in particular, be a permanent establishment, an administrative office, branch, factory, workshop, mine, quarry or any other place for the exploitation of natural resources, and a building site or place where construction and/or assembly works are carried out.<sup>107</sup> The PE concept refers to substantial physical presence in the country where services are rendered and goods are supplied. As per Article 2(10) of the VAT Proclamation, a permanent establishment exists where an enterprise has a fixed place of business located in Ethiopia. Hence, the enterprise must carry on business in Ethiopia through a fixed place.

In the conventional type of commerce, the PE concept provided by the VAT Proclamation can easily be applied but not in the case of e-commerce where the function is based on the application, i.e. web page, server, computers and cable.<sup>108</sup> This is because in e-commerce, traders can sell their products or services in a non-resident state even without the physical presence or establishment of PE. Therefore, the premises of the permanent-establishment rule which requires a presence of a business in each country does not always necessary to e-commerce transactions. Besides, the concept of fixed place in PE is difficult to apply in e-commerce as companies can be located anywhere and can conduct business everywhere.<sup>109</sup>

The question raised here is whether a website or a server, owned or used by a foreign company alone can constitute a permanent establishment. As per the revised commentary to Article 5 of the OECD Model Tax Convention, a non-resident enterprise with an internet web site alone would not be regarded as having a PE in the jurisdiction of its consumers.<sup>110</sup> This is based on the premise that a place of business test requires some physical existence in the source country. However, a website is not a tangible object, and therefore it cannot be a place of business.<sup>111</sup> Conversely, the server, being a physical object, can constitute a place of business.<sup>112</sup> Apart from the possibility that a server may be a place of substantial equipment, the room where the server is located would satisfy the concept of place of business.

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<sup>106</sup> VAT Proclamation 2002, supra note 31, Art. 4(7).

<sup>107</sup> Idem., Art. 2(10).

<sup>108</sup> Barrett Schaefer., ‘International Taxation of Electronic Commerce Income: A Proposal to Utilize Software Agents for Source-Based Taxation’, *Santa Clara High Technology journal* 2000- 16(1), P.117.

<sup>109</sup> Rifat Azam 2012, supra note 3, p.646.

<sup>110</sup> OECD, Clarification on The Application of The Permanent Establishment Definition In E-Commerce: Changes To The Commentary On The Model Tax Convention on Article 5, 2000, P. 3, at: <http://www.oecd.org/dataoecd/46/32/1923380.pdf> (accessed on 8 May 2020).

<sup>111</sup> Idem, P.5, Para. 42.2.

<sup>112</sup> Arvid A. Skaar., ‘Erosion of the Concept of Permanent Establishment: Electronic Commerce’, 28(5) *Intertax*, (2000), P. 189.

In summary, in the Ethiopian VAT Proclamation; the traditional concepts contained in the definition of a permanent establishment are inadequate to deal with the ever increasing growth of e-commerce in the digital era. In this context, it is therefore of utmost importance that a solution is developed to address the limitations of the present construction of the permanent establishment principle.

#### **IV.4. Deficiency of VAT Treaties**

The fact that, lack of uniform global legislation for regulating cross-border e-commerce taxation is a big impediment in itself. This means that different countries apply different standards when applying e-commerce tax law rules.<sup>113</sup> This may result in double taxation. Double taxation is defined as “the imposition of comparable taxes in two (or more) states on the same tax payer in respect of the same subject matter and for identical periods”.<sup>114</sup> This therefore implies that double taxation treaties have an important role to avoid double taxation. In Ethiopia, most tax treaties were created for income tax purposes. Indirect taxes such as VAT are usually left out of the multilateral and bilateral treaties between Ethiopia and other countries and this will create challenges when applying the existing VAT rules on e-commerce. In this respect, OECD, to minimize the risk of double taxation or under-taxation, has developed international VAT guidelines as an international standard for cross-border trade. These guidelines are based on the principles of good taxation such as neutrality, efficiency, legal security, simplicity, equity, and flexibility.<sup>115</sup> Consequently, to avoid issues of double taxation or non-taxation, future tax treaties should be created for VAT purposes while considering changes relating to taxation of e-commerce transactions.

Moreover, enforcement measures and penalties for non-compliance granting ERCA extraterritorial powers would have to be developed. These powers will not be enforceable unless tax treaties are in place between Ethiopia and the country in which the enforcement measures are to be imposed. Bilateral and multilateral treaties to realize the application of Ethiopian VAT law on cross-border e-commerce transaction would, therefore, must be negotiated.

#### **IV.5. Keeping Records**

In business, traders are expected to maintain proper accounts and records as required by the Tax Authority, so that they can have the required material as needed. Otherwise, it is difficult to properly manage the incomes and expenses of the business operation. To put it in a context, jurisdictions are encouraged to allow the use of electronic record keeping systems, as business processes have become increasingly automated and paper documents generally have been replaced by documents in an electronic format.<sup>116</sup> Accordingly, Article 37 of the VAT Proclamation requires every taxable person to keep records and books of account (which must be retained for up to ten years) in order to fulfill the requirements of the Proclamation.<sup>117</sup> However, in e-commerce transactions or when the taxable person engaged in the sale of electronic goods or services, no paper records are likely to be created.

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<sup>113</sup> Richard J. Vann., ‘International Aspects of Income Tax’, International Monetary Fund, 1998, Vol. 2, at: <https://www.imf.org/external/pubs/nft/1998/tlaw/eng/ch18.pdf> (accessed on 23 April 2020).

<sup>114</sup> Ibid.

<sup>115</sup> Van der Merwe B, ‘VAT and E-commerce’, *SA Mercantile Law Journal* 2003 -15(3), P. 389.

<sup>116</sup> OECD, International VAT/GST Guidelines, 2015, P. 53, at: <http://www.oecd.org/ctp/consumption/international-vat-gst-guidelines.pdf> (accessed on 12 May 2020).

<sup>117</sup> VAT Proclamation 2002, supra note 31, Art. 37.

In such cases, the only record that exists could be an electronic one. This creates the possibility for taxpayers to engage in tax evasion and fraud because computerised records can be altered without a trace. Correspondingly, in Ethiopia, guidelines regarding acceptable records or documents where goods are delivered, invoices issued and payments made electronically are not issued.

## V. Conclusion

The article discussed the impact of e-commerce on the VAT system in Ethiopia. In doing so, it showed how the existing legal regime relating to VAT in Ethiopia will be applicable for taxation of e-commerce. This demonstrated that the current VAT legislation in Ethiopia applies to e-commerce transactions. Nonetheless, there are many unanswered practical questions in the current VAT structure. In practice, e-commerce taxation especially for VAT purposes is not given due attention. Correspondingly, there is a lack of proper and adequate resources, and their usage, within the Tax Authority to monitor the business. Similarly, the absence of legal framework for completing an electronic business, lack of effective online payment system currently working at the international level, and stringent foreign exchange regulations are important barriers to the development of e-commerce in Ethiopia. As a result, the state continues to lose potential tax revenues from this sector.

Moreover, the article revealed the possible challenges posed in taxation of VAT on e-commerce under the Ethiopian VAT system. In view of that, the tax collection method of reverse-charge mechanism is inefficient to address situations where digital content was supplied to customers in Ethiopia. Because, it is mostly reliant on the honesty of the taxpayer to declare all imported e-commerce transactions that were incurred. This is challenging to control for the Ethiopian Tax Authority, and this may lead to tax evasion and the erosion of the tax base. Moreover, the work has shown that, the VAT system of Ethiopia does not have an effective mechanism to solve the problem of the buyer's identification, establishing his location/residence and its status (business or consumer). Similarly, it remains unclear how merchants could ascertain information about the buyers and how Tax Authority could trace electronic transactions.

The traditional definition of PE which is provided in the VAT Proclamation is also inadequate to deal with the ever-increasing growth of e-commerce transactions. Accordingly, the criteria of *fixed place of businesses* appear impractical since in e-commerce business can be placed and conducted anywhere without having any fixed place. Thus it can be established that the VAT Proclamation does not give a clear provision as to whether websites or server constitute permanent establishment that is subjected to tax.

Another setback identified in this work is that, Ethiopian tax treaties which address the problem of double taxation do not give much concern for VAT. There is also no guideline developed by Ethiopian Government as to acceptable records where goods are delivered, invoices issued and payments made by electronic means.

In conclusion, it is argued that the current Ethiopian legal system is not effective enough for the application of VAT on e-commerce transactions. Thus, the government of Ethiopia take into account the problems experienced and the adjustments made accordingly by the other jurisdictions.

This is to acknowledge how the existing VAT legislation is lacking in realizing VAT on e-commerce transactions.