

The Treatment of Ethiopian Consumer Cooperative Societies under the Ethiopian Income Tax and Value Added Tax Regime: Law and Practice[↓]

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Abstract

The economic and social contribution of Cooperative Societies is immense in Ethiopia. In recognition of this, Federal Co-operative Society Proclamation No_985/2016 exempt them from income tax with restrictions on their transaction. Yet, they are obliged to pay all other direct and indirect taxes including VAT. There has been a rampant complaint in many parts of the country over the transactions of these institutions and their income & VAT treatment. The article aims at examining the magnitude and manifestations of the problem of Consumer Cooperative Societies taxation in Addis Ababa city and other three regional states (Amhara, SNNP and Oromiya). To attain this, a qualitative research approach is employed in the course of which pertinent legislations, key informant interviews and literature have been explored, analyzed and synthesized. The FDRE Constitution, Ethiopian Cooperative Laws and other legislations are used as primary sources of data. Key informant interview has also been conducted with authorities in Federal and city administration Cooperative Agencies and Revenue Authorities. Additionally, books, articles, journals, and other relevant materials on the subject are examined as secondary data sources. Finally, the study concludes that the Consumer Cooperatives in the study area are transacting outside members without taking in to consideration the unique feature of ‘serving

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only members' and this income is treated as the income from Cooperative members; and there is no uniform system on levying and collecting of VAT., Therefore, Cooperative Agencies and Revenue Authorities of the country should exercise their mandate of regulating Co-operatives transaction and taxation.

Keywords: *Co-operatives taxation; VAT; Income tax; Transaction.*

Introduction

Co-operative is one of the universal phenomena through which a human will come together with others for shared interests. Such moves manifest as business institutions in modern times cooperative societies, as one of such business institutions, take on different characteristics depending on the specific interest it is established. Accordingly, different scholars and institutions define the concept in varying ways. In one of the widely, acclaimed definitions, Cooperative Societies Agency (ICA) defines it as “[a]n autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise.”¹ A closely similar definition of the concept has been also given by Cooperative Societies Proclamation of Ethiopia. From this definition, it is possible to infer the distinguishing features and principles of Co-operative Societies, including ‘serving their members most effectively and strengthening the Cooperatives movement. Particularly, Cooperatives pursue the goal of supporting each other and get product/service at lower price by creating a market linkage with other Cooperatives.

From these features and principles, one infers a legal presumption that the establishment of Cooperative Societies is not profit maximization. This

¹Ethiopia Agricultural and Transformation Plan, *Agricultural Cooperatives Sector Development Strategy*, 2012-2016, (June 2012), P.8.

presumption in turn arises from the principle of mutuality which portrays ‘no one can make profit from oneself’.² That is why, Cooperatives are exempt of income tax as profit motive is missing in their transaction. However, the mere exemption of income tax does not preclude the impact of indirect tax as this indirect tax is applied on specific aspect of transaction. Accordingly, there is neither any special benefit nor any additional compliance for a cooperative society on VAT and other indirect taxes.³

Similarly, in principle, Cooperative societies in Ethiopia *serve their members* most effectively and strengthen the cooperative movement by working together through local, national, regional and international structures.⁴ Also, there are exceptional circumstances where Cooperatives can give service to non-members.⁵ However, the income tax treatment of Cooperatives transaction with non-members on the conditions sated in Article 23 is not clear. Moreover, the Ethiopian VAT proclamation No. 285/2002 referred in Article 6(1) states that Co-operatives should pay VAT since indirect taxes are uniformly applicable for any form of business so long as there is a ‘*taxable transaction*’.⁶ Nevertheless, the practical applicability of these laws related with Cooperatives transaction, income tax, and VAT treatment in Ethiopia are

² Milind V. Sahasrabudhe, *Indirect Taxes Cooperative Banks / Housing*, (May 2010), p.3.

³ Id.

⁴ Co-operative Society proclamation of Ethiopia, Proclamation No.985/2016, Federal *Negarit Gazzeta* (2016), Article 5(6).

⁵ Id., Article 23.

⁶ “Taxable transaction” is an activity which is carried on continuously or regularly by any person in Ethiopia or partly in Ethiopia whether or *not* for a pecuniary profit that involves in whole or in part the supply of goods and services to another person for consideration.” Currently, Article 2(3) of the VAT amended proclamation No. 609/2008 states “the phrase “any person” also the phrase “activity which is carried on continuously or regularly” in Article 6 of the Proclamation are repealed and replaced by “any registered person” and “activity whether or not carried on continuously or regularly”.

not closely examined yet. Thus, this article examines the tax treatment of Ethiopian Consumer Co-operative Societies in Addis Ababa and other three regional cities of the country (Amhara, SNNP and Oromiya).

Qualitative research tools have been employed to explore the operation of the transaction and tax treatment in these institutions across the study cites. Both primary and secondary data were generated to attain the objectives of the investigation. In the secondary source, different books, articles, journals, and laws are reviewed and deeply examined as sources of secondary data. The primary data is collected through structured and unstructured interviews from *key informants* namely, Ethiopia Federal Cooperatives Agency and city Co-operative Societies Agencies. The other *key informants* are Federal Revenue Authority and Revenue Authority from each city of the three regions. Both purposive sampling and Simple Random sampling is employed to understand the grounds of tax exemption in practice on the taxation of co-operative societies in the capital cities of the above regions. In addition, Personal observation is made to scrutinize the transaction of Cooperative Societies with members and non-members. The data generated from these sources were analyzed and synthesized through qualitative method.

The Article is organized under three Sections. The first section deals with the theoretical framework of Cooperative Societies taxation. It highlights the Cooperatives income tax and VAT, specifically focusing on the pro and cons of Cooperatives income taxation. The second section discusses the tax treatment of Cooperative Societies in Ethiopia. This section emphasizes the legal and practical application of Cooperatives taxation in Ethiopia through an analysis of the transaction of Cooperatives and their income tax and VAT treatment. Finally, the last section provides concluding remarks and recommendations of institutional actions.

1. Cooperative Societies and Taxation: A Theoretical Framework

Individuals who conduct business have numerous options to determine the most appropriate way to pursue the particular business interest. The choice mainly depends on the desired characteristics of the business, including tax implications.⁷ They may take into consideration whether the business is exempted from income tax and other indirect taxes. In some countries, a co-operative society, as a special type of business organization is subject to direct and indirect taxes. Yet, in others, their contribution of easing socio-economic burdens of communities is recognized. Accordingly, governments provide them with several facilities, concessions and privileges including exemption from taxes.⁸ Because of these divergent practices of levying and the varying explanations, Cooperative Societies income taxation and VAT are controversial all over the world. The next section addresses such controversies and the issues underlying the arguments.

1.1. Direct Tax Treatment of Co-operative Societies: Income Tax Perspective

The controversy of Cooperatives income taxation arises from the absence of clear business boundary between members or non-members. The 6th ICA Principle and Paragraph 6(d) of the ILO R. 193 emphasize serving members effectively as an ultimate objective of the cooperation among cooperatives. But, the practicalities of these laws are doubtful and several member countries of these instruments allow co-operatives to transact with non-members. That is, a co-operative society may have a number of activities. As a result, the income from some activities may be exempted from income tax; whereas, income from other activities may not be exempted.⁹ In general, income tax

⁷ James R. Baarda, *Cooperatives and Income Tax Principles*, University of Arkansas, LLM Course, Published, (2007), p.1.

⁸ Daniel Ish, Some Aspects of the Taxation of Canadian Co-operatives, *Mc Gill Law Journal*, Vol.21, (1975), p.78.

⁹ CA Pramod Shingte Pune, *Taxation of Co-Operative Societies in India*, (2000), P.2.

exemption of co-operatives is a major subject of debate in policy practice and scholarly discourse.

1.1.1. Arguments in Favor of Income Tax Exemption of Cooperative Societies

The cooperative enterprise is conventionally held to be a non-profit institution guided by the principle of service for the benefit of patrons.¹⁰ Cooperation among cooperatives has been a feature of cooperatives since the beginning of their modern history in the mid nineteenth century. Now the sixth of the seven ICA principles introduced in 1995 lays down the statement on the cooperative identity. The 2001 UN Guidelines, the other document in related to this issue, creates a supportive environment for the development of cooperatives. Thirdly, the 2002 ILO Recommendation No. 193 concerning the promotion of cooperatives also emphasizes the importance of cooperation among cooperatives. These international instruments do not expressly regulate the way cooperatives should cooperate.

Consistent with the ideals of international documents, most countries in modern times provide several facilities, concessions and privileges, which are peculiar to such societies registered under Co-operative Societies Acts.¹¹ Among such facilities or concessions are facilities or concessions in respect of payment of income tax liability.¹² The main reason for the exemptions of tax and other privileges for these traditional co-operatives is dependents on the characteristics they owe. A Canadian scholar, Daniel Ish states that Co-operatives have been characterized, in contrast to ordinary business corporations, as lacking the speculative or profit making element.¹³ The main objective of the common business corporation is to reap a return to investors based on the amount of capital invested in the corporation by the shareholder,

¹⁰ Helmberger and Hoos, *Taxation of co-operative in USA*, (1962), p.20.

¹¹ Pune, *supra* note 9, P.1

¹² Id.

¹³ Id.

while the co-operative de-emphasizes the role of the member as investor and stresses his role as patrons.¹⁴

The aims of co-operatives are to socialize the interests of the members by eliminating or minimizing the role of the member qua investor and maximizing the role of the member qua patron, restricting the return on invested capital to a nominal rate. As such, it requires that the surplus of the co-operative be distributed to the members according to their patronage rather than their investment. Accordingly, it substitutes the capitalist principle of "one vote per share" for the co-operative principle of "one vote per member" regardless of the number of shares.¹⁵

A common view at the time was that a "true co-operative" by its very nature and mode of operation had no income of its own. This view was based on a number of theories. First, the co-operative acts as an agent for its members. Another, not totally distinct from the first, was that a co-operative was intended only to provide goods and services to members at its marginal cost rather than to produce profit.¹⁶ Thus, any surplus resulting from its operations was merely an adjustment in arriving at this fundamental object and was not income as such.

The quality of income test, of course, failed to be tenable as it can be shown that the sums held by the co-operative do not in fact belong to it. If one proves that the co-operative is the agent of the members ("agent" perhaps not always used in its strict legal sense), then the surplus is not taxable because the co-operatives' right to it is not unrestricted.¹⁷ It will be recalled that in

¹⁴ Ish, *supra* note 8, P.43.

¹⁵ Id.

¹⁶ A "price adjustment" theory of the operations of co-operatives has also been alluded to in Canadian jurisdictions. This theory is based on the premise that a true co-operative is intended only to provide goods and services to members at cost rather than to produce a profit. Patronage dividends paid out of surplus are deemed to be merely a price adjustment in arriving at this fundamental objective.

¹⁷ Ish, *supra* note 8, p.53.

Saskatchewan Wheat Pool case¹⁸ a similar ruling was reached, thereby establishing similar principles. The courts found the relationship between member and co-operative to be one of agency, trust or some contractual relationship less than a legal agency or trust. Thus, the court laid down the principle that a particular co-operative did not possess sufficient ownership in the surplus to be taxable on it.

The agency principle enunciated in *Saskatchewan Wheat Pool* has been followed often in cases involving marketing cooperatives. The Tax Appeal Board in 1952 held that a Manitoba dairy co-operative was exempt from taxation under the *Income War Tax Act* on the ground that the co-operative was acting as a mere "conduit pipe" of the members for the profits from the creamery operations.¹⁹

In general, the argument in favor of exemption of co-operatives from income tax depends on the ICA principle (serving only members), features of non-profit, and theories of agent-principal relationship between the agent and principal. The proponents hold that cooperatives are tax-exempt because they are not-for-profit. Technically, this is tenable because taxes aren't owed when there is no income.²⁰ Further, it is argued that the institutions are motivated not to by profit, but by delivery of services to their members at affordable price rate and required level of high quality .²¹ Similarly, the grant of this privilege to cooperatives may not literally help the government raise revenue, but it fulfills the mandate of easing the life burdens of people. Further, the tax exemption privilege under the law was made to enable the cooperatives

¹⁸ *M.N.R. v. The Saskatchewan Co-operative Wheat Producers Lt*), S.C.R.,402, (1928-34) (1930), As Cited in Daniel Ish, *supra* note 8, p. 47.

¹⁹ Ish, *supra* note 8, P.48.

²⁰ Jeffrey Pilcher, why Are Credit Unions Tax Exempt, available at: <https://thefinancialbrand.com/16153/why-credit-unions-have-a-tax-exemption>, (Accessed February 16, 2022).

²¹ Dagnachew Asrat & Addissie Shiferaw, *Law of Public Enterprises and Cooperatives: Teaching Material*, Prepared under the Sponsorship of the Justice and Legal System Research Institute, (2009), p. 140.

develop into viable and responsive economic enterprises and thereby fulfill its purpose of serving the need of the members.²² Thus, removing tax exemptions of cooperatives will deprive poor people the only organization that knows their conditions and which provides them what they need. Hence, it is strongly and unyieldingly opposed.²³

1.1.2. Arguments Against Income Tax Exemption of Cooperative Societies

Co-operatives have traditionally been regarded as non-profit making and only serve the members. Due to this reason, they were exempt of income tax. However, recently most countries co-operatives are not exempt of income tax. Because, co-operatives in several countries deviate from the characteristics of non-profit making purpose and exist as independent profit earning entity.²⁴

For example, in Canada the confusion led to the establishment of a Royal Commission²⁵ on Cooperatives to study the taxation of co-operatives prior to the resolution of the various problems in the courts. The Royal Commission (McDougall Commission) had a broad mandate to determine the most just and equitable means of taxing co-operatives. One important finding of the Commission was that co-operatives could indeed earn income and thus become liable to pay tax on the same. A co-operative was an entity, which of course is the necessary consequence of incorporation, and not merely a "price adjustment" agency. However, it was recognized that dividends which were

²²Daniel H., Against Repeal of Co-operatives Tax Privilege, available at: <http://www.cda.gov.ph/resources/updates/news/741-against-repeal-of-cooperative-tax-privilege>, (Accessed on February 16, 2022).

²³*Id.*

²⁴Ish, *supra* note 8, p.30.

²⁵The Royal Commission was established by Order in Council on Nov. 16, 1944. The Honorable Mr. Justice McDougall, Court of King's Bench, Quebec, was named chairman of the Commission.

paid to members by a co-operative could not be treated in the same way as profits of an ordinary business corporation.²⁶

The main recommendation of the Commission was that the then existing provision of the *Income War Tax Act*, which ostensibly exempted co-operatives from taxation, be repealed and the Act be amended to provide for the taxation of co-operatives on the same basis as other taxpayers. However, it was further recommended that all taxpayers be allowed to deduct patronage dividends "which are paid or credited to their customers in proportion to the quantity, quality or value of goods acquired, marketed, or sold or services rendered".²⁷ Then certain provisions were set out in a way they comply with the equitable rules of deducting patronage dividends. It is important to note that no attempt was made to place co-operatives in a privileged position in this respect; the deductions were available to all taxpayers, including partnerships and ordinary business corporations. One clear concession made to co-operatives was that newly formed co-operatives in their first three years of operation would obtain a complete exemption from taxation. The rationale behind this idea was that it was in the public interest to favor fledgling co-operatives, whose mortality rate had been high in the early years of operation because of their inherent inability to attract capital.²⁸

Similarly, in Zambia there is a general misconception on cooperatives that they are exempted from income tax. However, that is not the case because there is a limit to which income of a cooperative can be treated as exempt from being taxed. The exemption for cooperatives is conditional upon the cooperative meeting the exemption threshold set out in the Second Schedule to the Income Tax Act.²⁹

²⁶ Ish, *supra* note 8, p. 66.

²⁷ *Id.*, p.60.

²⁸ *Id.*

²⁹ Zambia Revenue Authority, *Taxation of Co-operatives*, (2016), p.1.

Moreover, in most countries co-operatives are divided in to two categories for income tax treatment purpose Viz, the non-income co-operative and co-operatives with income. In some countries a non-profit or exempt co-operative takes a third category.

The Non-profit (Exempt) co-operatives apply to organizations of a charitable nature or organizations which perform a function which is deemed to be in the public interest.³⁰ The reason for exempting co-operatives from paying income tax is not because of their co-cooperativeness *per se* but because of the purpose they serve in society. The rationale" of the exemptive provisions lies on the broad base of social policy. But, the taxation status of non-profit organizations has been criticized on the ground that certain entities, although of doubtful public benefit, in effect receive a public subsidy and an unfair competitive advantage by reason of their qualifying for exempt status.³¹ That's why; Co-operatives should also be required to meet a "public benefit" test to be exempt.

On the other hand, the non-income co-operative are not exempt of income tax. Co-operatives advance the argument in support of non-payment of taxes based on the premise that they are agents of their patron-members and have no taxable income. From this, it follows that funds received by co-operatives in the course of operation are not deemed to be income of the co-operative at all. There appears to be a legal inconsistency in treating the member-cooperative relationship as one of principal and agent on the one hand, while recognizing the separate legal entity of the cooperative on the other.³²

Further, there are other institutional features evidencing the absence of a true agency. For example, the co-operative usually conducts business in its own name, and holds title to property and employs its own people. These factors all must be considered in characterizing the agency relationship. Of course,

³⁰ Bryan A.Garner, *Black's law dictionary*, 8th edition, (2004), p.81.

³¹ Ish, *supra* note 8, p.40.

³² Id.

none of these factors is individually sufficient to determine this relationship. Yet it has been widely held that the cumulative effect is a strong indicator of the absence of an agency relationship.³³ Thus, as there is no true agent-principal relationship, the co-operatives entity should pay income tax.

The last type of cooperatives falling under the third tax category is widely known as income earning co-operatives. This category of institutions operates in many legal systems. Most of them operate not as non-profit organizations or as agents of their members, but as income earning type. It is clear that co-operatives do earn income and thus should be taxed on the same basis through which other intermediaries under the tax system are treated.³⁴ Co-operatives today are large business ventures permeating virtually all possible markets, and preferential tax treatment in these institutions is an issue. According to several scholars, preferential tax treatment amounts to a public subsidy of co-operatives, allowing them an unfair competitive advantage over non-co-operative taxpayers in similar businesses. Such differential tax treatment of business forms performing similar functions cannot be said to be equitable and neutral and should not subsist.³⁵

Historically, such question over equitability of preferential treatment has been a subject of controversy since the beginning of the 20th century in the west. The issue was particularly old and hot in England. In 1922, strong opposition arose among ordinary business men who considered that the cooperatives were sailing under false colors in claiming that cooperative dealings were distinguishable from ordinary business dealings.³⁶ In 1933, the tax collector and business viewpoint was stated by Mr. Hore-Belisha, Financial Secretary to the Treasury.³⁷ He pointed out that “as a good tax collector, there should be

³³ M.M.Caplin, *Taxing the Net Margins of Cooperatives*, 58 Geo. Lj (1969), p.74.

³⁴ Id.

³⁵ Id., p.78.

³⁶ Israel Packel, *Cooperatives and the Income Tax*, University Of Pennsylvania Law Review, (Dec, 1941), p.139.

³⁷ Id.

some limit to mutuality; ... otherwise the whole country might be covered by cooperatives and the government would receive no income tax.” Therefore, there need to be "equality of sacrifice as regards the Revenue which is a foundation of the common wealth and existence of the state."³⁸

1.1.3. Mutuality Vs Non-Mutuality Principle on Co-operatives Income Taxation

The application of the mutuality principle has been recognized and has continued to evolve over time from legal precedents originating in the UK, where limited legislative enactments have not denied but supported the application of the principle.³⁹ This principle implies that any income derived from oneself is not taxable for income tax purposes.⁴⁰

The mutuality principle was developed in the late 1800s at a time when individuals had to rely on their ability to self-insure for the provision of sickness and death benefits, as the insurance business had not yet evolved into an economically viable industry. Mutual organizations were created with the explicit purpose of providing insurance to their members whilst not deriving assessable profits or gains for their members.⁴¹

Modern forms of mutual entity cover a wide range of activities, such as recreation, sports, community services and co-operatives. Over the years, the mutuality principle has also been the subject of substantial legal litigation and a considerable body of legal precedents has been built up, from which the underlying concepts regarding the application of the mutuality principle is established.⁴² The most widely applied concepts of mutuality principle derived from the precedents include: the obligation on the part of the

³⁸ Hore-Belisha, *Co-operatives tax treatment in England*, (1933), p.20.

³⁹ Love & Natalie, *The Relevance of the Mutuality Principle within the Non-profit Sector*, *Third Sector Review*, Vol. 13, (2007), p.4.

⁴⁰ Id.

⁴¹ Id.

⁴² Id., p.6.

members to share a common purpose and the common fund to give effect to the common purpose ; the requirement for the members to have ownership and control of the common fund at all times ; the mandatory rule of complete identity between contributors and participants⁴³, and the possibility of surplus funds to be distributed to the members as mutual income.

Trading activities undertaken by the entity may be mutual or non-mutual in character: This shows that the mutuality principle does not exclude all profits and gains derived by the mutual entity from being classified as income under ordinary concepts and therefore as assessable income. Receipts from non-mutual sources such as the undertaking of commercial trading activities are assessable income to the entity. The nature and substance of a transaction determines the character of any profits derived as either mutual income (and therefore non-assessable) or non-mutual income (and therefore assessable). Further, the status of the parties to the transaction with the entity (that is, whether there is a membership relationship) is irrelevant. If the transactions are non-mutual in nature, the resultant surplus is taxable whether the transactions are with members or non-members. It depends entirely on whether it is a transaction entered into for commercial purposes.⁴⁴

For many years now it has been accepted that the principle of mutuality prevents certain receipts from forming taxable income in the hands of the recipient.⁴⁵ In other words, the general principle applicable to mutual concerns is that the surplus accruing to it cannot be regarded as income, profits or gains for the purpose of the Income Tax law.⁴⁶ The basic principle underlying herein is that no one can make profit out of himself. Even if any surplus is generated; it is not subject to tax as it is exempt based on the 'concept of Mutuality'. The cardinal requirement in case of mutual association is that 'all the contributors to the common fund must be entitled to

⁴³ Pune, *supra* note 9, p.3.

⁴⁴ *Id.*

⁴⁵ *British Broadcasting Corporation V. John*, UK High Court, (June, 1990).

⁴⁶ pune , *supra* note 9, p.2 .

participate in the surplus & all the participators to the surplus must be contributors to the common trade.⁴⁷ In other words there should be complete identity between the contributors and the participators.

Modern form of mutual entity in several countries includes co-operatives but not limited to it. Co-operative is normally considered to be an entity where the members come together to achieve common goals by sharing fruits of common labour.⁴⁸ The individual members may come and go, but the members as a class remains the same and hence, so long as group of members or individuals are covered under members, the transactions with them are covered under principle of mutuality and thus, need not be subject to tax.⁴⁹

Therefore, these features suggest a presumption that it is a form of mutual entity where members contribute and work for their own benefits inter-se. Accordingly, taxation of such co-operatives is always perceived to be on different footing relative to other form of pure commercial organizations.⁵⁰ This shows when people work between themselves, contribute money within themselves and enjoy the fruits of such efforts within themselves; the entity is considered to be mutual benefit entity. In effect, there is no contribution from outsider and there is no flow of fruits to outsider.

The rational for exemption of co-operatives from income tax is, therefore, derived from the mutuality principle, i.e., mutuality of transactions precludes income tax thereon and recognized, in general law, that a person cannot make a profit from himself. Similarly, if co-operative societies get any profit and income arising from a cooperative society's transactions with its members, it is exempt of income tax. The surplus arising out of contributions from

⁴⁷ Id.

⁴⁸ Milind V. Sahasrabudhe, *Indirect Taxes Cooperative Banks / Housing*, (May 2010), p.3.

⁴⁹ Id.

⁵⁰ Id.

members is not a taxable income as the same is governed by the concept of mutuality.⁵¹

However, any income derived from business dealings with non-members is fully taxable because the contrary reading of mutuality principle proves the fact that the income earned by a person from external source is taxable. As such, transactions with outsiders shall be taxed provided there is taxable surplus from such transactions. Thus, just because entity is formed as cooperative society, it does not mean all its transactions will be covered by mutuality. In sum, Income of co-operative society other than surplus from contributions from members is taxable subject to deductions.⁵²

1.2. Indirect Tax Treatment of Co-operative Societies: VAT Perspective

Mutuality of transactions precludes income tax thereon. Clearly nobody can make profit out of oneself. Yet, does it essentially preclude impact of indirect taxes? The answer is 'NO'; this is because indirect tax is applied to specific aspect of transactions.⁵³ A typical case in point is VAT. VAT, as a broad tax regime, is designed to bring within its charge every kind of economic transaction, subject to limited exceptions. This is normally achieved by drafting a broad provision imposing VAT on an extremely wide range of business transactions and then removing, through a specific exception, any transaction that is not to be liable.⁵⁴ On this regard, some countries exempt co-operative societies from VAT tax through such specific exception. The justification for their exemption is that:

⁵¹Love L., Concept of Mutuality, available at: <http://www.caclubindia.com/article/concept-of-mutuality-a-discussion/> (Accessed March 15,2022).

⁵² CA Ramesh S Prabhu, *Taxation of Co-Operative Societies*: 80P of Income Tax Act,(1961) , P.9.

⁵³ Milind V. Sahasrabudhe, *supra* note 2, p.7.

⁵⁴ Bekure Herouy, *The VAT Regime Under Ethiopian Law with Special Emphasis on Tax Exemption: The Ethiopian and International Experience*, (March 2004), p.20.

“Cooperative societies are not economic operators and as such they are not carrying on economic activities and the services they render are not taxable if such services are rendered to their members free of charge. Therefore, these cooperative societies are entitled to operate on specific conditions which are out of scope of VAT.”⁵⁵

On the other hand, the VAT law in most countries includes all legal persons created under the law of the state (or of a foreign country) that are engaged in economic activities of any kind, as well as all physical persons to pay VAT.⁵⁶ Governmental bodies at the national, regional, and local levels are to be included as taxable persons, in the same way as any other person, if they get engage in economic activity.⁵⁷ These premises suggest that all co-operative societies which can get profit from its transaction with their members should pay VAT.

Finally, it is important to note that transactions are usually stated to be within the scope of VAT if they are "supplies of goods or services." These terms are given extremely wide meanings that go significantly beyond the usual meanings of "supplies," "goods," and "services" in most languages. The aim is to bring within the charge all economic activity.⁵⁸ Further, VAT is a tax on supplies made in the course or furtherance of economic activity, or, put another way, as part of a business.⁵⁹ It should therefore be confined to activities of this nature and not be imposed on other activities such as the personal hobbies of an individual, gifts made for personal reasons, or

⁵⁵ Gunta Kaulina, *Planned amendments to Value Added Law*, KPMG, (2016), P.1.

⁵⁶ *Id.*

⁵⁷ Mohammed Abdullah Al Mehrezi, *Value Added Tax (VAT)*, (1998), p.22.

⁵⁸ *Id.*, p. 21.

⁵⁹ The phrase "economic activity" is based on the EC Sixth VAT Directive, art. 4. This is chosen from the range described in this note because it is felt the term is best fitted to be translated widely. The scope of the term is wider than "business," in the sense that the term tends to imply only profitable activities. Profit is irrelevant to VAT (although the profit motive is not). note, however, there are alternative approaches.

charitable activities with no business or commercial content.⁶⁰ However, a co-operative society which furthers the economy of the members is dealing with taxable service and should pay VAT though they are not-for-profit.

Above all, a person is a taxable person (or in some countries a registered person) if he makes taxable sales above a threshold amount and such sales are made in connection with certain economic or taxable activity. A taxable activity for VAT purposes generally is broader than the concept of trade for income tax purposes.⁶¹

2. Tax Treatment of Cooperative Societies under Ethiopian Law & its Applicability

Co-operative societies are established on the basis of freedom of association which is safeguarded under international, regional human right laws and those

⁶⁰ David Williams, *Value-Added Tax, Tax Law Design and Drafting; International Monetary Fund*: volume 1, (1996), p.32.

⁶¹ The tests include:

- *Continuity*

Supplies should be made regularly and fairly frequently as part of a continuing activity. Isolated or single transactions will not usually be liable to VAT.

- *Value*

The supplies should be for a significant amount; trivial, even if repeated, transactions would not usually count.

- *Profit (in the Accounting Sense)*

Not necessary; after all, large concerns can create substantial value added and pay large sums in wages, yet make no profit (many publicly owned firms do precisely this). Such firms should certainly pay VAT.

- *Active Control*

Control should be in the hands of the supplier. He should be actively engaged in the “control or management of the assets concerned” (including operation through an agent). The proprietor should be independent and, hence, should be excluded from coverage.

- *Intra- Versus Inter-trade*

Supplies should be to members outside the organization and not just between members of the organization.

- *Appearance of Business*

The activities should have the characteristics of a normal commercial undertaking with some acceptable method of record keeping in place.

under the FDRE Constitution. Currently, the Federal government of Ethiopia enacted a law on cooperative society under Proclamation No. 985/2016. The applicability of the law is on all co-operatives established in the country.⁶² the next sections examine the contents of the proclamation vis-à-vis the stipulations in international documents and experiences of other countries.

2.1. Transaction of Cooperative Societies in Ethiopia

The 6th ICA Principle and Paragraph 6(d) of the ILO R. 193 unequivocally obligate cooperatives to serve the members of the cooperating entities.⁶³ This obligation apparently suggests that co-operatives are not allowed to provide services and sell goods to non-members. However, the practicability of this legal restriction on co-operatives transaction with non-members in Ethiopia is doubtful and requires rigorous investigation of the practice. The next sections take an examination of the practical application of these laws.

The co-operative proclamation of Ethiopia share common percepts with the ICA over co-operative society: As such, it defines the term as: “autonomous association having legal personality and democratically controlled by persons united voluntarily to meet their common economic, social and cultural needs and other aspirations, which could not addressed individually, through an enterprise jointly owned and operated on the basis of cooperative principles”,⁶⁴

Looking closer into this definition, one would notice phrases construing the legislative intents of the lawmakers. To this end, cooperatives are entrusted with the obligation “...to meet the common economic, social and cultural needs of members”. This feature is also supported by the values of Cooperative societies which include self-help, self-responsibility, democracy,

⁶² Co-operative Society Proclamation, *supra* note 4, Article 3.

⁶³ Hagen Henry, Cooperation, Concentration and Value Chains: Legal and Implications in Terms of Cooperative Principles, ICA 2018 research conference, (July 2018), P. 40.

⁶⁴ Co-operative Society Proclamation, *supra* note 4, Article 2(1).

equality, equity and solidarity.⁶⁵ Similarly, Cooperative members are expected to be guided by the ethical values of honesty, openness, participation, social responsibility and caring for others.⁶⁶ The foundational principles of cooperatives are the outcomes of these values. In other words, these values underlie the principles cooperation regarded as an essential of the cooperative spirit in this legislative provision.

The other provision worth considering in this respect is Article 5 which lists out the seven principles of Cooperative society. The principles closely reflect the contents of those in the ICA. These principles are also a base for their change and growth as shown in *Mondragon Co-operatives* and others. Reflecting the common core of the principles from the two documents, Article 5(6) states: “Cooperative societies shall serve their members most effectively and strengthen the cooperative movement by working together through local, national, regional and international structures.” As such, the content of this principle is a verbatim copy of the 6th ICA principle of co-operations while it draws the insight of the court ruling. This provision also clearly sets out that co-operatives in principle should serve their members most effectively. In addition, this legal provision is supported by Article 23 of Cooperatives proclamation which listed out the four conditions under which Cooperatives give service to non-members:

“The conditions under which cooperative societies give service to non-members shall be based on contract and for the following purposes: distributing inputs supplied by government to increase productivity and production, distributing consumable products supplied by government to balance supply and demand, distributing revolving funds and social service to the society availed by different development partners and supply agricultural inputs and collect agricultural products from farmers engaged in farming.”⁶⁷

⁶⁵ Id., Article 6 (1).

⁶⁶ Id., Article 6 (2).

⁶⁷ Id., Article 23 (1)(a-d).

In listing the conditions, the law makers make the existence of a contract a mandatory element of the conditions. Also, the provision, while it makes the existence of purpose for rendering cooperative service, an essential element of the condition, it limits the number of purposes to five through an exhaustive list. In other words, the contrary reading of this provision would mean that except for the listed purposes, co-operatives are not allowed to serve non-members in any way.

Thus, except on the conditions listed in Article 23 (1), co-operatives are not allowed to serve non-members and get profit from that. They should only serve the members and not focus on profit maximization. Of course, the proclamation under Articles 23(2) requires the details for the implementation of sub-Article (1) of Article 23 to be determined in the by-laws of the cooperative society. By-law is defined, under Article 2 (13) of the proclamation, as the law governing a cooperatives society including amendments made to it and approved by 2/3 vote of the general assembly and registered by appropriate body upon fulfilling particulars specified under Article 12 of this same proclamation. Currently, there are several by-laws of Co-operative societies, and they need to be checked for any contradiction against the principle of serving members. Also, a regulation on the implementation of Cooperative Societies proclamation has been drafted. Yet the promulgation is delayed so long causing further problems .⁶⁸

However, cooperative societies are unsuccessful in realizing their institutional mission stipulated in the law. The practice of this unique features and principles of co-operatives in Ethiopia seems distant from the law. According to Federal Cooperative Agency (FCA) official report of 2021, there are more than 92,755 cooperatives in Ethiopia with 21,043,370 members (6,743,429 female and 14,299,941 male). The numbers of employment opportunities created by Cooperative societies are 1,987,379. According to the same official

⁶⁸ Interview with Tesfaye Beyene, Legal Expert IV, Federal Cooperative Societies Agency (May, 14,2022)

report, there are 131 unions in the area. These cooperatives can be producers' cooperatives, marketing cooperatives, saving and credit cooperatives, consumer cooperatives, handcrafts cooperatives, mining cooperatives, housing cooperatives, construction cooperatives, multipurpose cooperatives and services cooperatives, among others.

The study further investigated the practice of the consumer cooperatives transaction in Addis Ababa city and other three regions of Ethiopia (Amhara, SNNP and Oromiya). Based on this investigation, the provision of service is not limited to members and most of the cooperatives are engaged in trade activities. For example, in Addis Ababa city, the numbers of consumer cooperatives are huge in number⁶⁹ and increasing rapidly from time to time comparing to other cooperative societies in the city.⁷⁰ To uncover the problem at greater depth, the researchers selected three sub-cities (*Arada, Bole and Ledeta*) out of the 11 sub-cities of Addis Ababa. Yet from these three sub-cities, the authors also randomly selected three Woredas from each sub-city. The evidence from this investigation in these target areas shows that, the Cooperatives in Addis Ababa city are almost profit-making institutions. They transact with members and non-members without any limit. The Cooperatives sell agricultural products, industrial products and others to non-members with no restriction.⁷¹ Further, they are engaged in service businesses such as hotels, Restaurants, Grocery and others. To mention a sample case, *Shala Hotel Cooperative Societies Limited Liability, is established* as a cooperative societies institution. Yet this institution is officially a meat supplier to all societies of the city and a whole sealer of Beer and other beverages to the community in Bole area of Addis Ababa.⁷² Surprisingly, the

⁶⁹ Interview with Habetamu Webetu, Legal Expert, Addis Ababa Cooperative Societies Agency (May 14,2022).

⁷⁰ Id.

⁷¹ Interview with Sentayo Tesema, Cooperative Societies Office Market Study Higher Expert, Arada Sub-city (May, 15,2022).

⁷² Interview with Mokriya Abdu, Cooperatives transaction group leader, Addis Ababa Cooperative Societies Agency, (May 15,2022).

authors observed Co-operatives engagement in super-markets businesses where they sell cosmetics products. One respondent also replied that, there is high corruption on Co-operatives transaction like; selling the subsidized product to traders at high price, hiding the goods to create shortage of that product and selling to friends, etc. The respondent believes that, the Cooperatives are a collection of rich traders and they hold a false name of cooperative and they are highly exposed to corruption.⁷³

The authors also made an observation of the *Exhibition* organized by Addis Ababa Co-operatives Agency with a leading *theme of* “Co-operative Societies transaction for peaceful and stable market” undertaken from May 26-28, 2022. In the exhibition, the researchers could observe the Cooperatives selling a variety of products such as egg, vegetables, potato, onion, honey and other products which other ordinary traders do. The transactions in the exhibition were not limited to the products stated in Article 23 of the proclamation rather it incorporates every form of transaction to members and non-members.

After that, the authors visited the regulatory institutions of the city, namely Addis Ababa Cooperative Societies Agency and each sub-cities Cooperative society office. The institutions were well aware about the ***Exhibition*** as they facilitate such transaction with non-members. Most of the regulatory institutions are positive towards the transaction of Co-operative societies with non-members. Also, they justify their actions and attitude on a number of grounds. For example they pointed out that there are some products subsidized by the government for controlling the current inflation and these products should also be available to all residents of the city. Also, they believe that the service shouldn't be limited to members. Rather non-members should also be allowed to buy the goods.⁷⁴

⁷³ Interview with Habetamu Webetu, *supra* note 69

⁷⁴ Interview with Dagne Kebede, Cooperatives inspection and legal expert group leader, Arada Sub-city, (May, 15,2022).

For example, in this fiscal year, nearly 1000,000,000 (one Billion) ETB was provided as a revolving fund for Addis Ababa Cooperative Agency to supply Teff and Wheat at lower price. As a result, the product is sold at a price of 40 ETB per Killo to all residents of the city who have a residence identification card (ID card).⁷⁵

An attempt has been made to look into the processes of utilizing such fund against the stipulation under Article 23 (1c) of the Cooperatives Proclamation. The evidences from the examination, shows that the exception of distributing revolving funds and social services to the society availed by different development partners is misused and embezzled by the city cooperatives. Similarly, the informants reported that the sky rocketing inflation of the city can be relaxed through supplying goods and services to the residents of the city by cooperative societies. It is really helpful to stabilize the market.⁷⁶ Finally, the authorities unduly tried to justify their actions on the ground of 'community concern'.

Like those in Addis Ababa, most respondents from the three regions of Ethiopia (Amhara, SNNP and Oromiya) agreed on the fact that Cooperatives, contrary to their missions, engage in different transactions with non-members. Asked about the legality of cooperatives transaction with non-members, some respondents pointed out that the Cooperative Societies Proclamation does not prohibit the transaction with non-members.⁷⁷ Yet a much deeper conversation with them reveals that they do not understand the features and principles set out in Article 5(6) of the proclamation and the contrary reading of Article 23.

⁷⁵ Interview with Gizachew Ali, Director, Addis Ababa Cooperative Agency, (May, 15,2022).

⁷⁶ Id.

⁷⁷ Interview with Seyum Muluneh, Auditor, SNNP Cooperative Societies Agency, (May,20,2022); Interview with Belachew Assefa , Director, Oromiya Cooperative Societies Agency, (May,25,2022).

A slightly different opinion is also reflected by a respondent from Amhara regional state who remarked that, though the proclamation is dedicated only to members under Article 5, the Cooperatives' transaction with non-members will help them increase the number of members. The respondent further noted that, unless they transact with non-members, no one could understand the benefit of co-operatives and join it as a member. So, such transaction will be an opportunity for them to show non-members what benefits could be gained if they join the membership.⁷⁸ However, the authors would object to this point of view on the ground that if non-members are able to find all the benefits that members of Cooperatives enjoy, what factors would encouraged others to join Cooperative Societies? It will have rather a discouraging effect on non-members to become members of Cooperative Societies.

Finally, the authors continued their journey to the Federal Cooperative Societies Agency and ask inquire into the above activities of Cooperatives of the country. The respondent replied that the consumers' co-operative boundless transaction with non-members in Addis Ababa city and the other three regional states is not lawful. It discourages and minimizes the interest of becoming a member of the co-operatives and may also negatively affect the healthy business makers in the city. The Co-operative Societies Agency in the target areas should, as per it mandate, regulate cooperatives 'transaction with non-members and ensure their compliance with the law.'⁷⁹

2.2. Income Tax Treatment of Cooperative Societies in Ethiopia

It has been reiterated so far that cooperatives are created mainly to serve the interest of its members. This is expressly stated in pertinent laws regulating their operation. Yet this over emphasis on the service of members begs the question as to whether the cooperatives are granted a special treatment by the relevant laws of the country. The Ethiopian Income Tax Proclamation No.

⁷⁸ Interview with Getenet Mengesha, team leader, Amhara Regional State Cooperative Societies Agency, (May, 12,2020).

⁷⁹ Interview with Tesfaye Beyene, *supra* note 68

979/2016, one of the relevant laws, in principle exempts *non-profit organizations* from in-come tax. Yet this exemption covers the income of [such institutions] other than business income that is not directly related to the core functions of the organization”.⁸⁰ Finally, it is important to note that the proclamation , though employs the term non-profit organization, does not mention *cooperative societies* per se . Thus, these privileges can apply only through close scrutiny of the transactions carried out by the institution in question.

An explicit mention of Cooperative Societies is made in Proclamation No. 985/2016 which also provides an income tax privilege to Cooperatives. According to this legislation , the members of cooperatives are required to pay income tax on their dividends and shares from participation..⁸¹ Moreover, Article 45 (1) of the proclamation states that any cooperative society shall deduct 30% of the net profit and allocate for the reserve fund. The amount allocated for the reserve fund shall continue to be deducted until it reaches 30% of the capital of the cooperative society and it shall be deposited in the saving account of the society.” It is also stipulated under sub-Article 2 that the distribution of the remaining 70% net profit be determined by the general assembly. Apart from this, the general assembly, through a by-law, may allocate budget for education, training, for auditing funds, or social services and incentivizing actions of institutions. The resource for financing all these purposes can be drawn only from a net profit based by-law of the cooperative society.

The reserve and capital of the co-operatives is exempt of income tax as the current co-operative proclamation exempts the Co-operatives from income tax at entity level by explicitly stating; “without prejudice to incentives permitted under investment laws and other laws, any cooperative society

⁸⁰ Income Tax proclamation, Proclamation No. 979/2016, Federal *Negarit Gazetta*, (2016), Article 65 (7m).

⁸¹Co-operative Society Proclamation, *supra* note 4, Article 43(1a).

which is organized and registered in accordance with this Proclamation shall be entitled to supports and incentives; *be exempted from income tax....*⁸²

The reason for this privilege might be to encourage the co-operation for achieving the objectives set out in the preamble and Article 4 of the proclamation. Moreover, the exemption tends to justify *the public utility of cooperatives* and the *mutuality principle* underlying the mission of the institution. Thus, one can argue that the spirit of the Ethiopian co-operative proclamation can be inferred from the definition, feature, principles and other provisions which mainly aim to *serve their members most effectively*.

To this effect, the proclamation makes direct a direct reference to the mutuality principle in the preamble in which it seeks to make people “bring together their finance, knowledge, resource and labour voluntarily to meet their common economic, social and cultural needs and other aspirations which would then allow *mutual support* and create savings.”

The grant of this privilege to cooperatives is meant to fulfill the goal of easing poverty among the mass while limiting government revenue. However, the authors would argue that these aspirations remain unfulfilled and the ideals of non-profit institutions are becoming nearly obsolete because of the weak institutional capacity to enforce the laws formulated to regulate them. This has also become true in several countries where cooperatives deviate from the characteristics of non-profit making purpose and exist as independent profit earning entity. As a result, they are not exempted from the income tax.

Apart from the institutional inefficiency, the current Co-operative proclamation of Ethiopia contains a couple of ambiguities. The proclamation presumes cooperatives transaction be limited to members. At the same time, it exceptionally permits Cooperatives to transact with non-members under

⁸² Co-operative Society Proclamation, *supra* note 4, Article 43(1a).

Article 23. Still, the law is silent on the taxation of income to be levied from non-members under such conditions. Even though it is silent, the basic principles of co-operatives income taxation (Mutuality and Non-mutuality) can be a base line to solve this problem. The rationale for exemption of co-operatives from income tax is derived from the mutuality principle which recognizes in general law that a person cannot make a profit from him/herself. Similarly, if co-operative societies get any profit and income arising from a cooperative society's transactions with its members it is exempt of income tax. However, any income derived from business dealings with non-members need to be taxed as the contrary reading of mutuality principle also suggests that the income earned by a person from external source is taxable. As such, transactions with outsiders shall be taxed provided there is taxable surplus from such transactions. Thus, just because entity is formed as cooperative society, it does not mean all its transactions will be covered by mutuality. Income of co-operative society other than surplus from contributions of members is taxable.⁸³

In this regard, the authors would hold that the income generated through the conditions listed in Article 23 of the proclamation and other conditions listed for outside members should be taxed. This is mainly because non-mutuality principle dictates that any income derived from business dealings with non-members is fully taxable.

In practice, the Cooperatives in Addis Ababa city and other three regional capital city (Bahardiar, Adama and Hawassa) transact with non-members not only in the above conditions but also on different activities and conditions without any restriction. As confirmed above, consumer co-operatives are almost involved in trade and sale to individuals and others who are not members of the Co-operatives. Thus, the co-operatives in the cities are making profit by selling primary consumable goods listed in Article 23 and

⁸³ CA Ramesh S Prabhu, *Taxation of Co-operative Societies* : 80P of Income Tax Act,(1961) , p.9.

transacting with non-members.⁸⁴ However, the income generated through this process is receives treatment similar to the income from members. In effect it is not taxed.

Among others, there is no book record which distinguishes income from members and non-members though it is orally reported to each co-operative.⁸⁵ Due to this reason, any cooperative societies reserve fund, which is required to be deposited in the saving account (30% of the net profit), is free from income tax. All respondents from Addis Ababa city and three regional states revealed that Co-operative societies are free from income tax regardless of whatever the source of the income (from members or non-members). Most of them explained that although Co-operative societies transact with non-members, there is no legal reason to force them pay income tax even on benefits derived from non-members.⁸⁶ Revealing, one of the scrupulous actions happening in the institution, one respondent from Addis Ababa Co-operative Agency reported that for becoming a trader, individuals should come as Co-operative societies and he/she will be privileged technically. All the traders should act as Cooperatives and will benefit more by transacting with whom so ever they need. Now, a trader in Addis Ababa knows that and work's under a guise of Cooperatives and it's the associations of rich individual's instead of poor people. It is also open for corruption; the Co-operatives sold to traders and sometimes put in a buried warehouse. But, still there is no distinguished tax imposition on this transaction.⁸⁷

The authors went to the Federal Revenue Authority, each region Revenue Authority and other Revenue Offices of the cities to make interview on issues relating to the illegal and unlawful activities of Co-operatives exemption of an

⁸⁴ Interview with Tesfaye Beyene, *supra* note 68.

⁸⁵ Interview with Abere Asefaw, Legal Director, Ethiopian Revenue Authority, (May, 17,2022).

⁸⁶ Interview with Fantaye Haile, Tesefa Co-operative Societies in Addis Ababa City, (May, 16,2022) & Interview with Getachew Fentahun Merkeb, Farmers Union, Amhara Regional State, (May,12,2022).

⁸⁷ Interview with Habetamu Wubetu, *supra* note 70.

income found from non-members. Most of the respondents were not well-aware on the taxation of an income found from non-members and few of them angered by the activities of Co-operatives. Finally, most of them agreed to implement the law and collect an income generated from the transaction with non-members transaction of Co-operative Societies.

Now we turn to the tax related to dividend, Article 43(1) of the proclamation which states that co-operative members shall pay income tax on their dividend at the rate of 10% of the gross value of the dividend. This co-operatives dividend, widely known in other countries as patronage refunds, stays for long as non-taxable rather deductible income. Recently, when patrons/members receive patronage refunds/dividends, they are required to expect that their share is taxable at the rate of 10 %. However, it is still contentious as to whether this 10% of dividend should be paid at the individual level or at primary/union/federation Cooperatives level. Two competing arguments can be found in the literature.

The first argument takes the view that the law, in using the phrase “...*that the members shall pay income tax on their dividends...*” in general and the word “...*Members...*” in particular shows that dividends are required to be paid at levels of individual members. People advancing this argument substantiate their points by making a reference to Article 2(10) of the proclamation which defines *member* as “any individual or a primary cooperative society or a cooperative societies union or cooperative society’s federation who applied and admitted for membership upon fulfilling the minimum membership requirements.” Thus, because the individuals are members of primary co-operatives, the primary co-operatives are itself the members of unions and the unions are also members of the federation co-operatives, these all members of the co-operatives receive dividend at each level. Thus, the dividend should be paid at each level of the co-operatives as they receive dividend from each co-operative chains.

Turning to the other argument, others hold that dividend should only be paid at the final receipt of individual members (i.e. the individual members of primary co-operatives only) to avoid double taxation of cooperatives. The proponents of this argument base their claim on the Amharic version of Article 43(1a) which reads; “...ሆኖም ግለሰብ አባላት ከሕገ/ ማክበራቸው ጋር በሚያደርጉት ተሳትፎና በገዢነት ዕጣ መጠን ከሚያገኙት ገቢ ላይ አጣጥቦ ባለው ሕግ መሰረት የገቢ ግብር ይከፍላሉ”⁸⁸. This version of the provision employs the phrase “individual members”, thereby making these subjects final recipients, Whereas the English version translated as “...the individual members shall pay income tax on their dividends based on the value of their share and transaction...” used “members” of both individual and other cooperatives to pay dividends.

These arguments were at the center of the scholarly and policy debate for a long time. The authors also investigated the rounds of both sides. Based on these analysis of the contents of the arguments, they would suggest the second grounds of argument (10% of dividend at individual level) as a viable interpretation of the law. This is because the Amharic version of the proclamation prevails over the English version of this law. It also avoids the double taxation of Co-operative societies. Similarly, in several countries including USA, only the final recipient of the income, the cooperative's patron/member, receives income on which tax is to be paid. This tax concept is usually called the "single tax principle".⁸⁸ As a result, the current practice of cooperatives dividend taxation in Ethiopia is only at the final receipt of individual member's level in all cities of the country. A circular is distributed to all regions of the country and other federal cities.⁸⁹

Thus, 10 % of dividend from the 70% of co-operatives net income should be paid at individual level not at entity level. From the 70% net profit, the general assembly may allocate for education, training, incentive, audit fund, or for

⁸⁸ James R. Baarda, *Cooperatives and Income Tax Principles*, University of Arkansas, LLM Course, (2007), p. 154.

⁸⁹ Interview with Ato Tesfayo Beyene, *supra* note 68.

social service.⁹⁰ However, a closer look into this provision of shows that it takes a gross permissive position for financing the six activities (education, training, incentives, audit fund and social services). Yet no clear stipulation is made as to the amount—out of the 70% net profit to be allocated to each purpose. It is widely left to the discretion of the general assembly to determine the amount to finance vital activities such as social service. However, the new draft co-operative regulation .../ 2018/9 allocates 3% of the 70% net profit for social purposes. The researchers would take this move as an encouraging step towards addressing public interest. Yet it needs further effort to take the permissive position of the law to a mandatory status both in the regulation and the proclamation.

Taking the broader landscape, one would argue that an equal treatment of income tax from non- members and members (at 10% dividend) may create several problems. Among others, the government may lose high tax revenue as it only collects 10% from both members and non-members income instead of the business income tax schedule (which can be up-to 35%) and all traders who are the main source of income may also shift to co-operatives business. Similarly, this tax profit generated non-members' transaction may create unfair business competition between traders and co-operatives.

In practice, Cooperatives in Addis Ababa city and other regional states indicate that members of cooperative societies are paying dividend income tax in cases where the share is distributed among members. But, it is not strict and sometimes if the members agree that the dividend is funded to increase the capital of the Co-operative society then there will be no tax from it. Most respondents of the interview believe that the cooperatives should get high dividend from the service and this can also attract other non-members to join the cooperatives. There are sometimes conditions where individual members

⁹⁰ Federal Cooperatives Proclamation, *supra* note 4, Article 45.

did not pay tax even from the dividend.⁹¹ The high income of cooperatives from members and non-members transaction is encouraged. Similarly, some responded that the cooperatives tax payment of 10% is burdensome. Something different is envisaged in Amahara regional States Cooperative Society Agency. People from this institution take the view that if the income is obtained from non-members, such profit obtained from transaction with non-members will be taken directly to increase the capital of the Co-operative societies and neither will be divided among members nor pay income tax on it and the researchers accept as it is in accordance with the law.

2.3. VAT Treatment of Co-operative Societies in Ethiopia

Ethiopia joined what is now a large chorus of nations in the world by introducing the value added tax (VAT) in 2002 (effective January 2003).⁹² The VAT which replaced sales tax is a multiple-stage sales tax with the ability to reach all levels of economic distribution (manufacture, wholesale and retail).⁹³ Currently, the Minister of Finance and Economic Development increased the threshold of annual volume of transaction of businesses subject to VAT through circular from half a million to one million based on the power given in Article 16(2) of the 285/2002 .

On the other hand, for those businesses whose annual volume of trade did not reach 1 million birr, another tax was introduced along with the VAT, namely the turnover tax. The novelty as well as structural complexity of the VAT is

⁹¹ Interview with Ato Tayo Masersha, Directorate Director, Addis Ababa Revenue office Income tax administration, (May 15, 2022).

⁹² The value added tax has become one of the most remarkable fiscal phenomena of the modern times. All but one (i.e., the USA) of the industrial nations have adopted the VAT as one major source of government revenue, and more than 150 nations have now adopted VAT as their favorite indirect tax. In Africa, Ethiopia was the 36th African nation to catch the VAT-bug, As cited in Tadesse Lencho article on *To Tax or Not to Tax: is that Really the Question*, p 265.

⁹³ Tadesse Lencho, *To Tax Or Not To Tax: Is That Really The Question? VAT, Bank Foreclosure Sales, and the Scope of Exemptions for Financial Services in Ethiopia*, *Mizan Law Review*, Vol. 5 No.2, (Dec. 2011), p.265.

such that small and medium-sized businesses could not be immediately brought within the umbrella of the VAT system.⁹⁴

Although VAT is generally recognized as a broad-based general sales tax, the VAT laws of Ethiopia came out with a fairly long list of exemptions for certain transactions in goods and services.⁹⁵ However, in these VAT laws there are no provisions which exempt co-operative societies from payment of VAT. The assumption of non-profit motive of co-operatives only exempts them from income tax but not from VAT. This is because VAT does not take into consideration the motive behind a business. i.e., for profit or not. Rather it is applied to specific aspect of transaction. In other words, the key to the application of VAT to domestic supplies of goods and services is the notion of ‘taxable transactions’.⁹⁶ Every supply of goods or services must be a taxable transaction before VAT attaches to it. Article 7(3) of the VAT proclamation, as such, defines a taxable transaction as: “...a supply of goods or rendition of services in Ethiopia in the course or furtherance of a taxable activity other than an exempt supply.”

From this definition, we can see that the three elements of taxable transactions in Ethiopia and in the course or furtherance of a taxable activity are fulfilled in Cooperative Societies transaction. First, with regard to, the supply of goods or services, co-operative societies which include primary, federation, union and

⁹⁴ Id., p.266

⁹⁵ VAT Proclamation, Proclamation No. 285/2002, Federal *Negarit Gazetta*, (2002), Article 8(2).

⁹⁶ VAT (Amendment) Proclamation, Proclamation No. 609/2008, Federal *Negarit Gazetta*, (2008), Article 7(1)(a):

Subject to the provisions of this proclamation and subject to Sub-Article (2), there shall be levied and paid a tax, to be known as value added tax, at the rate of 15 percent of the value of-

- (a) every taxable transaction by a registered person; and
- (b) every import of goods, other than an exempt import; and
- (c) an import of services as provided in Article 23, and , Article 3 of the VAT Proclamation which prescribes the scope of application of VAT; taxable transactions, imports of goods and import of services; for imports, it is not at all necessary for the imports to be taxable transactions.

league may be established to engage in production or service rendering activities or both in production and service rendering activities.⁹⁷ Further, this provision of the proclamation suggests the possibility that co-operatives can engage on the supply of goods and services to attract VAT. Similarly, the notion of ‘taxable activity’ which consists of at least three elements (continuity or regularity, involvement or intention to get involved in a supply for consideration and evidence of being carried on in Ethiopia or partly in Ethiopia) are also fulfilled by the Ethiopian co-operatives to be eligible for VAT. To this effect, Article 2(3) of the VAT amended proclamation 609/2008 explicitly states that phrases such as “any person” and “activity which is carried on continuously or regularly” employed in Article 6 of the former Proclamation are repealed and replaced by “any registered person” and “activity whether or not carried on continuously or regularly” respectively. This shows, the first element of VAT is met in the current proclamation.

In addition, the phrase “...*whether or not for pecuniary profit*...” in the definition part shows Profit motive in business is not essential for the purpose of eligibility to VAT. It is also immaterial whether cooperatives earn profit or incurs loss. Thus, co-operative societies, even if engaged in the trading activities at no-profit-no-loss basis, are liable to pay tax on their sales.

As a result, the current Ethiopian co-operative proclamation obliges the co-operatives to pay all indirect taxes including VAT.⁹⁸ Particularly, the cumulative reading of Article 18 (3) and Article 43 (1a) suggest that co-operative societies are only exempt of income tax but not VAT. Co-operatives are obliged to pay all indirect tax including VAT as there is taxable transaction and consumption within their members and sometimes outside members which are the bases for VAT.

⁹⁷ Federal Cooperatives Proclamation, *supra* note 4, Article 8.

⁹⁸ Article 18(3):

“...*except income tax cooperative Societies shall pay the necessary payments to government according to the law and on time*”.

Moreover, VAT is imposed on the value added to the goods or services in each transaction. In Cooperative Societies there is also a value addition and this can be inferred from Article 21 (2F & 3g) of the proclamation which states. “...*Primary or Union cooperative societies can engage in collecting members product, add value and submit to their....*”⁹⁹. From this, it can be deduced that the transactions of cooperatives are taxable transaction. Every cooperatives of the country whose annual transaction is more than a million is obliged to register for VAT and pay to the government by collecting it in each transaction. If the transaction is less than one million, cooperatives should pay alternatively turn over tax.

However, the evidence from the current investigation indicates that most of the Cooperatives in Addis Ababa city and other three regions of Ethiopia (Amhara, SNNP and Oromiya) are not practically indebted to pay VAT. Specially, the primary Cooperatives in the above three regions and in the city of Addis Ababa are not paying VAT. Similarly, except few Union Cooperatives & some Federation Cooperatives which are registered voluntarily, most are exempted from VAT.¹⁰⁰

Respondents participating in the interview revealed a couple of reasons responsible for poor performance in the implementation of VAT laws. Some pointed out that there is lack of knowledge on the legal framework of the country related with VAT payment of Co-operative societies. Particularly, those some of the respondents engaged in varying businesses are not well-aware related to the obligation of VAT payment of Co-operatives in general.

⁹⁹ Article 21: Duties and Responsibilities of Cooperative Societies:

2(f)-*Primary cooperative Societies shall, mainly, engage in activities that are beyond the capacities of individual members and solve common economic and social problems and in particular shall include the following: collect members product, add value and submit to their union or federation, or sale by searching for better market outlets;*

3(g)-*Cooperative Societies unions shall, mainly, engage in activities that are beyond the capacities of member primary cooperative Societies and solve common economic and social problems and in particular shall include the following: add value on member's product and perform other activities as described in their by-laws.*

¹⁰⁰ Interview with Belachew Asef, Director, Adama city revenue bureau, (May 12,2022).

Similarly, others engaged on the cooperatives business are not also well aware on the obligation to register for VAT.¹⁰¹ They did not consider the self-assessment obligation and raise the lack of knowledge defense to Revenue Authority. The Authority in each sub-cities and Woreda of the above four cities oblige cooperatives pay VAT along with its interest thereto, and this becomes sometimes a source of complaint.¹⁰² Thus, the authors could confirm that there is confusion on the legal regime of Cooperatives law with regard to VAT payment. Also, in some areas of the regions, there were situations where Cooperatives were exempt through circular letters from VAT payment.¹⁰³ Some of the reasons mentioned in the circulars are the fact that co-operatives are non-profit and deal with social subordination instead of profit making. The authors find the justification mentioned in the circular over co-operatives exemption from VAT so weak. For example, the exemption on the justification of non-profit making is fallacious because in the proclamation profit making characteristics of the institutions is implied in several provisions such as; Article 4(4) "...finding better market prices to their products or services"; Article 5(3) "Members shall receive dividends from surplus"; Article 12(1j); "...allocation and distribution of profit"; Article 21(2F) "...collect members product, add value and submit to their union or federation, or sale by searching for better market outlets"; Article 35(5) "decide the distribution of the annual net profit of the cooperative society"; Article 45(2)"... The distribution of the remaining 70% net profit...". Each phrase of these articles contains the word "Profit" or "Surplus", suggesting the profit earning features of Ethiopian co-operatives. If the co-operatives are presumed to be non-profit from the outset, why should the law make them exempt of income tax as entity? So, co-operatives get profit from members and non-members and pay tax at 10% dividend at individual level.

¹⁰¹ Interview with Ato Habetamu Webetu, *supra* note 69

¹⁰² Interview with Ato Tesfaye Beyene, *supra* note 68.

¹⁰³ Id.

Moreover, some other respondents also revealed that, though they are aware of, they believe that registering for VAT increases the price of the goods or services to the members and non-members of Cooperatives. As a result, the cooperatives intentionally disregard the registration to VAT though the annual income is greater than 1 million.¹⁰⁴ Further, few Cooperatives in SNNP region and Amhara region collect VAT from the cooperatives transaction but not refund to the government. They hold the money and consider as income of the Cooperatives. Thus, there are irregularities from the government in collecting VAT from Cooperative societies.¹⁰⁵

Finally, most Cooperatives who do co-operatives business in the study sites responded that consumer co-operatives are exempt of indirect taxes including VAT. Only Federation cooperatives and few Union cooperatives are registered for VAT payment voluntarily. The reason for this volunteer registration is to avoid/minimize the challenges they face during market search for the product including, exporting products to abroad.

Concluding Remarks

The contribution of Cooperative Societies is so enormous in societies living with multifaceted socio-economic challenges. Due to this reason, the government of Ethiopia provides several privileges and facilities such as exemption from income tax. This governmental policy is mainly meant to encourage co-operation and depend on mutuality principle. Consistent with these assumptions, co-operative Societies have unique features that distinguish them from other forms of business organization. Among others, they pursue the goal of promoting the interests of their members and do business only or mainly with their members as they exist solely to serve their members. The 6th ICA Principle and Paragraph 6(d) of the ILO R. 193 emphasize the same objective of the cooperation among cooperatives. The

¹⁰⁴ Interview with Ato Gizachew Ali, *supra* note 75.

¹⁰⁵ Interview with Bogale Borsamo, Expert on Tax, Southern Nations Nationalities Regional Cooperative Societies Agency (May, 20,2022).

Co-operative proclamation of Ethiopia which in force in the federal and other regional states of the country is almost a verbatim copy of these international documents. Principally, Article 5(6) and Article 23 of the proclamation expressly state the unique features and principles of *'serving only members of the co-operatives'*.

Nevertheless, the practical realization of the aspirations underlying the principles are very poor across Addis Ababa city and other three regions of Ethiopia (Amhara, SNNP and Oromiya). The Consumer Co-operatives transact with non-members on all conditions without following the chain of primary-federation. They buy and sell from/to non-members not only on the permitted conditions of Article 23 but also on all circumstances. They do trade through selling the goods at lower price without taking into consideration the restrictions laid down in the law.

The host of violation of the law is compounded with the untenable position of pertinent legislations on income tax treatment of cooperatives. The law is silent on the taxation of income found from non-members in the above conditions. Due to this reason, the Cooperatives in general and Consumer Cooperatives in particular are taxed in a similar way by disregarding the source of Cooperatives income in Addis Ababa city and other regions of the country. This crude taxation system of Cooperatives affects the national economy in different ways. Thus, the Co-operatives law should have a clear provision which distinguishes income from members and non-members for the purpose of tax. The income of Co-operatives from non-members on the conditions of Article 23 and others conditions should be taxed in a similar way to other ordinary business makers. The Co-operatives which generate income from non-members' transaction should be taxed similar to Schedule "C" of the income tax proclamation imposed on business person which is taxed up-to the rate of 35% and 30% at individual and entity level respectively. The Revenue Authority of each region and cities of Ethiopia should implement this tax rate on Cooperatives.

Finally, the current Ethiopian Co-operative proclamation obliged the Co-operatives to pay all indirect taxes including VAT. Principally, Article 18 (3) cumulative with Article 43 (1a) of the Co-operative Societies proclamation makes Co-operatives duty bound to pay VAT as there is taxable transaction. However, in Addis Ababa city and other three regions of Ethiopia (Amhara, SNNP and Oromiya), Consumer Cooperatives are not paying VAT. The government is not strict or consistent in imposing VAT on Cooperatives though their annual transaction is greater than 1 million. Except federation Cooperatives and few Union Co-operatives, other consumer Cooperatives are not registered and paying VAT. Thus, the Revenue Authority should apply the Co-operatives law and collect VAT from co-operatives in study sites.