NEW TAX RULING BY THE CASSATION BENCH OF THE FEDERAL SUPREME COURT OF ETHIOPIA

BDO Ethiopia

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A new ruling was released by the Federal Supreme Court on April 5, 2023, addressing the payment of 10% tax on undistributed profit that is utilized to pay up the shareholder's subscribed capital.

According to Article 61 of the Income Tax Proclamation Number 979/2016, 10% of the company's undistributed profit that hasn't been reinvested must be paid in tax.

In addition to this, Article 6 of Directive No. 7/2011 issued by the Ministry of Finance which guides the proper implementation of the above-mentioned article explains that a company is considered to have used its undistributed earnings to expand capital in the form of reinvestment if the following conditions are met:

1. A company has increased its capital and shareholders' shares using the company's net profit within 12 months following the closing of its financial year.
2. Company Minutes of shareholders that has been authenticated by the Documents Authentication and Registration Service or regional/city administration offices and a document from the Ministry of Trade or any authorized body that explains the capital increase are present.
3. The company has notified the tax office by presenting all the required documentary evidence that the undistributed profits have been used for capital increase within two months after the expiry of the 12-month period stated under (1) above.

A company is said to have used its undistributed profit for an increment of its capital and will not be required to pay 10% tax from the undistributed profit, if and only if the above procedures are carefully followed and the company provides evidence that shows the capital increase has been made during the 12-month period following the closing of the financial year.

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On April 5, 2023, the Federal Supreme Court Cassation Bench upheld the rulings of the Federal Higher Court and the Federal Supreme Court Appeal Benches that using undistributed profit to pay up the previously subscribed shares is a debt recovery, which cannot be considered as a capital increase and, consequently, 10% tax shall be paid on the amount of profits used for such settlements.

BASIC PREMISES FOR THE RULING

- The capital of the company, which was the subject of the ruling, was increased by the shares subscribed to by the shareholders in 2004 E.C.
- The capital of the company has not been increased since 2004 E.C.
- The business license of 2008 E.C. does not show a capital increase.
- One of the conditions for capital increase through capitalization of the profits of the 2008 E.C financial year, which requires presentation of documentary evidence, was not fulfilled.

TAKEAWAYS

- Subscription for new shares results in an increase in capital at the time of subscription, which is also provided under Article 457 (4) of the 2021 Commercial Code of Ethiopia.
- The use of company profits to pay up previously subscribed shares will not be considered as capital increase.

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