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Overcoming Mixed Supply Challenges: How VAT Proclamation No. 1341/2024 Addresses the Issue

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The VAT Regime of Ethiopia

VAT was introduced in Ethiopia in January 2003, replacing the sales tax initially governed by the Sales and Excise Tax Proclamation No. 68/193 and the subsequent VAT Proclamation No. 285/2002 referred below as the 'old VAT proclamation' with its subsequent amendments. However, since July 4th, 2024, VAT in Ethiopia is being administered by the new value-added tax Proclamation No. 1341/2024, referred to as 'the new proclamation' in this article. This proclamation repeals the old proclamation and its subsequent regulations and directives to the extent that they are not inconsistent with the new proclamation.

In the past years, there were several directives issued following the old proclamation and its amendments. One of those directives was Mixed Supplies Directive No. 20/2001, which provides the apportionment formula for credit allowed in the case of mixed supplies. Later this directive was repealed by VAT refund processing directive no. 148/2011, which was the base for the challenge and confusion on taxpayers and the tax authority officers related to the input VAT credit allowable amount in case of mixed supplies. The central idea of this article is to go deep down what the challenge was, the confusion, and what the new VAT proclamation has changed regarding VAT credit in the case of mixed supplies.

Concept of Mixed Supply and its Treatment

The mixed supplies concept and its treatment in the new proclamation is the same as the old VAT proclamations, except that the new proclamation elaborates the concept more and adds new sub articles to cover different scenarios for the treatment of mixed supplies.

Basically, the reason for inclusion of mixed supply concept is for application of VAT rule differently to a transaction that involves more than one element, each of which would, if viewed separately, have a different character. Viewed individually, the elements of the transaction may be broken down into: (i) a taxable supply; (ii) an exempt supply; (iii) a zero-rated supply; or (iv) a transaction outside the scope of VAT.

However, if the elements of a transaction are viewed as a single supply, taking its character from its principal element, all elements of the supply would share the same VAT treatment. This can arise not only because of the classifi-

cation of supplies as exempt or zero-rated supplies, but also if the place of supply or time of supply rules apply differently to each element of the supply.

Article 20, sub-article 1 of the new VAT proclamation stated that a supply of goods that is incidental to a supply of services is treated as part of the supply of services. In this case, for example, the servicing of an item of equipment may involve the replacement of some parts. If the replacement of parts is incidental to the servicing of the equipment, the whole transaction is treated as a supply of services for the purposes of VAT.

In addition, under sub-article 2 of this article, it is stated that a supply of services that is incidental to a supply of goods is treated as part of the supply of goods. In this case, for example, the sale and installation of substantial capital equipment will involve both a supply of goods (the equipment) and a supply of services (the installation of the equipment). If the installation services are incidental to the supply of goods, the whole transaction is treated as a supply of goods for the purposes of VAT.

Moreover, as per the explanation note of the new VAT proclamation, a particular element of a transaction will be incidental to a principal element if it does not constitute an aim in itself but is merely a means by which the recipient can better enjoy the principal element. In contrast, if circumstances indicate that what the recipient intended to purchase were two or more distinct supplies, and if those supplies are made for a single price, it will be necessary to apportion the price between those elements of the transaction. The method of apportionment should give a true reflection of the comparative values of each of the separate supplies, keeping in mind the need for the apportionment method to be simple and practical for the supplier to use. For this reason, sub article 4 of article 20 of the new proclamation empowers the Tax Authority to determine the extent to which a supply is treated as a supply of goods or a supply of services on any reasonable basis when sub articles 1 and 2 discussed above do not apply.

Having said the above, this article will focus on the VAT credit on mixed supplies because the apportionment was a big challenge as a result of the fact that input VAT credit is not allowed if the input purchased is used for the production of nontaxable goods or services.

Mixed Supply and VAT Credit

With the above concept in mind and the similarity on the old and new VAT proclamation, both stipulate VAT credit, and it provides that in respect of taxable transactions, the input tax paid and allocable is entirely refundable or credited while the input tax allocable on exempt transactions is not creditable. Whereas in respect of input tax of a supply allocable to both taxable and exempt, the law says that the rule of apportionment of the credit is determined by the directive to be issued by the Ministry of Revenue (MOR).

The mixed supplies directive No. 20/2001 and VAT refund processing directive No. 148/2011 were issued, respectively, following this provision on the old proclamation to enable implementation of VAT credit and refund, including input VAT allocable to both taxable and exempt supply.

The first directive stipulates a formula for apportionment of the VAT credit, which is in line with the concept of the proclamation. However, Article 4 sub article 2 of the later directive specifically provides how input tax is prorated to both taxable and exempt supply. The later directive does not provide a formula except it states under sub article 2(a) that 'if the taxable sales amount within the accounting period divided by the total sales amount, which is taxable and exempt, resulted in greater than 90%, the input tax allocated to taxable supply can be fully offset or credited. And under sub-article 2(b), it reads, 'If the taxable sales amount within the accounting period divided by the total sales amount resulted in less than 90%, the VAT paid on input cannot be claimed'.

The Challenge and Confusion:

How Directive No. 148/2011 was contrary to the spirit of VAT proclamation.

The challenge and confusion of the VAT credit and refund related to mixed supply emanates from the VAT Refund Processing Directive No. 148/2011 Article 2(b). This directive was issued to replace the old Mixed Supplies Directive No. 20/2001 that clearly puts a formula to determine the apportionment of the credit.

This directive prevented the VAT credit right on considerable apportionment of allocable input tax of taxable supply. What makes this directive inconsistent with the proclamation is that in view of this directive, if taxable sales are

less than 90% of the total sales, the taxpayer is unable to recover all input VAT or claim input VAT given that exempted sales are greater than 10%. For instance, if the proportion of taxable supply becomes 89%, the article does not allow VAT credit or refund, which is not logical at all. The directive does not have a rule of convenience/de minimis rule as well. This provision in the directive has been contradicted not only with the old and the new VAT proclamation; it also contradicts with equity and fairness principles of taxation.

In connection, if input VAT ends up with no credit, the directive does not specify any alternative method for refund of input VAT. In practice, the tax authority accepts VAT as a cost based on Deductible Expenses Directive 5/2011, which provides a room that VAT that has not been credited could be accounted for as a cost while determining taxable income for annual corporate income tax. However, this practice has been adversely impacting taxpayers' cash flow position, which has had a detrimental effect on the taxpayers' business. Furthermore, the cost of supplies (goods and services) has been inadvertently overstated, impacting the taxable profit itself and reducing the CIT computed at year ends.

Moreover, in practice, the mixed supply concept implementation used to confuse the tax officers; some were using the repealed directive, which was consistent with the VAT proclamation, while others used to follow directive 148/2011, which is inconsistent with the proclamation as discussed above.

Illustration

There were different sectors experiencing VAT credit challenges resulting from mixed supplies issues. One of these includes the dairy sector. Dairy production companies produce fresh milk, pasteurized milk, fermented milk, fruit-flavored milk, cream, butter (i.e., used to make bread, cosmetics, table, and cooking butter), cheese (e.g., mozzarella, cottage cheese, smoked and cream cheese), and yoghurt (natural and fruit-flavored). Milk is packed in plastic pouches, yoghurt in plastic cups, and butter is packed using plastic film and foil.

These companies purchase taxable input (inputs purchased with VAT) and use this input for production of both taxable and nontaxable outputs. For instance, they purchase taxable input for the production of fresh milk, which is exempted from VAT (nontaxable), and cream

and yoghurt, which are taxable supplies.

They were facing the input VAT credit challenge discussed above and the subsequent compliance costs.

This was not the end of the story. It was obvious that this challenge on the production companies would have adversely impacted the market/consumers as tax measures automatically change the behavior of the taxpayers in terms of the production pattern. For instance, if we take the dairy companies, they are engaged in the above-mentioned products; however, due to such wrong imposition of tax measures, they tend to produce more products that will let them enjoy VAT monthly credit, such as yoghurt and cheese, rather than producing exempt supplies (such as milk), which is an important social product.

Moreover, it is also obvious that price would have increased when VAT is considered as a cost by the production companies because all costs are considered for price setting by the companies. As a result, the product, for instance, milk, would have ended up with an inflated price that the market/consumers can't afford to purchase and consume. I believe milk is a basic supply that its costs should not be impacted by VAT, and citizens shall consume this basic product at a fair price.

How the challenge and confusion are Solved

The new VAT proclamation endorsed the apportionment formula that was introduced by Mixed Supplies Directive No. 20/2001 in 2008 G.C. with an adjustment on the de minimis rule, i.e., the fraction for the de minimis rule is increased from 0.90 to 0.95 and 0.5.

Article 29 sub-Article 2 of the new VAT Proclamation provides a formula (same formula that was provided on Directive 20/2001) to determine the amount of the input tax credit allowed for a creditable acquisition that is acquired partly to make taxable supplies and partly to make other supplies (such as exempt supplies) or out-of-scope supplies (such as foreign supplies). The apportionment formula is as below:

$$\text{Amount of Tax Credit} = A \times B/C$$

where:

'A' is the total amount of tax payable in respect of creditable acquisitions made by the registered person during the month, partly to make taxable supplies and partly to make other

supplies.

'B' is the total value of taxable supplies made by the registered person during the month.

'C' is the total value of all supplies (taxable, exempt, and other supplies) made by the registered person during the month.

Above is a general apportionment rule that applies. Further to this, the proclamation provides a de minimis rule for convenience purposes and to minimize administration cost in complying with the mixed supply calculation from the taxpayer side and the tax authority side.

For this purpose, the VAT law provided two rules of convenience. The first one is if the fraction **B/C** in the above formula is 0.95 or more (i.e., where 95% or more of the value of total supplies during the month are taxable), credit is allowed for the full amount of input tax. This may apply, for example, where a company makes small amounts of exempt supplies. This means that the tax authority absorbs or bears the VAT on input that the company paid in relation to the acquisition of input for the production of a small amount of exempted supplies and a significant amount of taxable supplies.

On the other hand, where the fraction **B/C** is less than 0.05 (i.e., where less than 5% of the value of total supplies made during the month are taxable supplies), credit is denied for the full amount of input tax. In such cases, it means that the taxpayer absorbs or bears the input VAT paid in acquiring input for the production of small amounts of taxable supplies and significant amounts of exempted supplies.

Simulation of the formula

Below is a simulation to show the above discussed scenarios.

Description	Credit Allowed for the full (100% input VAT) amount as per the de minimis rule—tax authority to absorb the input tax	Credit allowed as per application of the mixed supplies formula.		Credit Denied the full amount of input VAT as per the de minimis rule—the taxpayer to absorb the input tax.
The total amount of input tax payable in the month = A	*200	200	200	200
The total value of taxable supplies in the month = B	400	400	400	400
The total value of all supplies (taxable, exempt, and other supplies) in the month = C	415	450	4000	9000
Input tax credit allowed = A*B/C	192.77	*177.78	*20.00	8.89
de minimis rule test for full acceptance or denial of input VAT	96%	89%	10%	4%

Note: Marked as * in the table are VAT credit amounts allowed.

Finally, under Article 74 of the new VAT proclamation, it is stated that regulations and directives issued under the repealed law (i.e., the old proclamation) shall continue to apply to the extent that they are not inconsistent with the new proclamation, and until such time they are replaced by regulations and directives issued under the new VAT proclamation.

Therefore, even though the VAT Refund Processing Directive No. 148/2011 contains other articles that are consistent with the new VAT proclamation, article 2(b) is inconsistent and can be said to be repealed, and those companies having VAT credit challenges on mixed supply are relieved.■



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