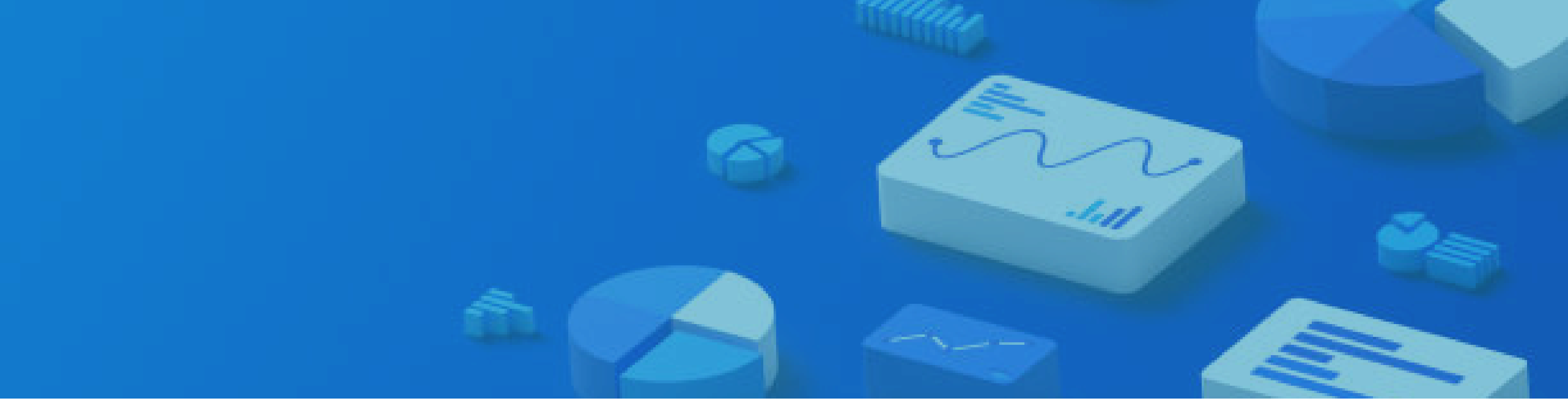

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Commentary on the Budget Speech FY 2081-82 (2024-2025) - Investment in Nepal

In 2023, global FDI flows saw a decline in accordance with OECD and UNCTAD. Despite the downturn, Asia continued to do better to attract investment with East and Southeast Asia taking the lead. Nepal approved NPR 7.22 billion (approx. USD 54.04 million) in FDI for the fiscal year 2022/23. Service (41.1%) and tourism (41.1 %) attracted the most FDI, followed by manufacturing (8.89 %), IT (4.9 %), and infrastructure (3.06 %).

The recent past years have seen efforts made by the Government of Nepal (GON) to improve the foreign investment climate of Nepal. Some of the key reforms are (i) implementation of Automatic Route for making foreign investment, (ii) reduction of minimum FDI threshold from NPR 50 million to NPR 20 million, (iii) removal of minimum FDI threshold for ICT sector (applicable only for FDI made via Automatic Route), and (iv) complete waiver of fees for company registration and capital increment for Fiscal Year 2080/81. Most of the aforementioned reforms were enacted by the GON after they were proposed in the previous fiscal years' federal budget.

Similarly, a set of investment and industry related laws have been amended this year to make the investment atmosphere more conducive. The "Bill to Amend Some Nepal Acts Related to Investment Facilitation" (the "Amendments") came into effect on 8 July 2024. The Amendments brought in the following key important changes:

Foreign Investment and Technology Transfer Act 2019 (2075) (“FITTA”)

- **Contract manufacturing is now permitted without limitation.** Prior to amendment it was only permitted for production of ancillary or subsidiary products. This will aid business expansion of Nepalese industries.
- **“Reverse Engineering” has been recognized as a form of Technology Transfer.** Reverse Engineering may enable Nepalese industries to gain valuable insights and potentially develop their own innovations.
- **Nepalese businesses can transfer technology to foreign businesses,** but they need prior approval from the Nepalese central bank to receive foreign currency payment for it. Additionally, they have the option to open a branch office in foreign countries to facilitate the technology transfer process. This should also help Nepalese businesses grow.
- **Foreign investment is permitted up to 70% in ride-sharing business.** Before this, there was a lack of clarity on the investment route of such businesses because they were not recognized by law. Previously, ride-sharing businesses in Nepal were mostly operating as “software platform” industry. The FITTA amendment has addressed this ambiguity and solidified the legal standing of ride-sharing business.
- **Department of Industry (DOI) has become the foreign investment approving body**. Previously, DOI handled approvals for foreign investments under NPR 6 billion, while Investment Board Nepal (IBN) made approvals above NPR 6 billion. Now, the DOI can approve foreign investment without any limit. However, the Public Private Partnership and Investment Act 2019 (“PPPIA”) still authorizes IBN to approve projects having cost above NPR 6 billion. This inconsistency between FITTA and PPPIA remains to be resolved.

Industrial Enterprises Act 2020 (2076) (“IEA”)

- **IEA recognizes a Startup Business and provides for its registration, operation, promotion and facilities.** IEA has prescribed certain criteria for a venture to qualify as a Startup Business. Start-up businesses will be regulated by the federal, provincial and local level government, and such governments will operate “Business Incubation Centre” to promote startups. These governments have been empowered to provide facilities, concessions and incentives to Startup Business. The introduction of these legal provisions is expected to boost the rise and administration of startups in Nepal..

- **The timeline for seeking additional documents for industry registration has been reduced from 90 days to 21 days.** Industry registration of a business is essential for many purposes like obtaining EXIM Code for import, obtaining environmental clearance, and obtaining license from relevant regulatory bodies. However, investors previously faced delays due to the DOI frequently requesting additional documents over extended periods. This often postponed commercial operations. The new IEA amendment should expedite the industry registration process, allowing businesses to launch their businesses in a timely manner.
- **Industries can request extension of commercial operation at any point of time**, which is unlike before when applications for extension had to be filed 30 days before expiry of commercial operation period. In many instances in the past, Nepalese businesses faced challenges starting operations within the timeframe allowed by their industry registration certificate. In some cases, businesses faced delay fees for failing to start operations within the initial timeframe. Missing three extension deadlines would render their registration inactive, effectively shutting them down. The IEA amendment will allow industries to continue their activities without having to worry about recurring extensions.
- To stimulate growth in the IT sector, the **GON shall offer facilities and incentives to IT companies with equity capital over NPR 1 billion.** This initiative is expected to encourage both the expansion of existing IT businesses and the establishment of new ones.
- **Contract manufacturing is now permitted without limitation.** Prior to amendment it was only permitted for production of ancillary or subsidiary products. This will aid business expansion of Nepalese industries.

Special Economic Zone Act, 2018 (2073) (“SEZA”)

- **Existing industries can transfer their existing machineries and equipment into SEZ and operate their business there.** Previously, investors who were interested in transferring their industry or opening a unit in SEZ were restricted from transferring used machineries and equipment into SEZ. This repelled investors from SEZ. This reform, allowing existing businesses to relocate with their operational equipment, is expected to boost investment in Nepal's SEZs.

- **SEZ industries now have a reduced export requirement, starting with a minimum of 15% for the first 4 years and at least 30% afterwards.** Before the SEZA amendment, industries in SEZ had to mandatorily export 60% of their production, which was a high threshold that was difficult to meet for all businesses. Failure to meet the 60% target also resulted in penalties. This reform should make business operation in SEZ more attractive.
- **Industries in SEZ can commence sale in domestic market within 3 years after establishment**. Prior to SEZA amendment, SEZ businesses had to sell their product and service in the domestic market within 1 year from industry establishment. Failure to comply resulted in penalties like license cancellation, closing of industry, fine upto NPR 15 lakh. The legal change could make SEZ more attractive for investors.

The federal budget for the Fiscal Year 2024- 2025 (2081-82 B.S.) (the "Budget") published by the Ministry of Finance has identified "Improvement of Business Environment" as one the five strategies for economic reform of Nepal. Said strategy aims to bring about changes with regards to
(i) Revision of Investment and Industry Laws,
(ii) Increment of Technology Transfer Fees Sent to Foreign Countries,
(iii) Reinvestment of Earnings from Technology Transfer in Foreign Countries,
(iv) Establishment of Investment Companies to Foster Business,
(v) Guarantee of Policy Stability and Investment Security,
(vi) Credit Rating, and
(vii) Development of Double Tax Avoidance Agreement.

Investment related Changes Proposed by the Budget:

i. Revision of Investment and Industry Laws

The Budget announced revision of investment and industry laws including Industrial Enterprises Act 2020, Direct Sales Act 2018, Insolvency Act 2006, Labor Act 2018, Hedging Rules, Companies Act 2006, regulations for Operation and Management of Industrial Area, Forest Act 2019, and Land Acquisition Act 1977. This revision of the laws seeks to modernize them and ensure their relevance in today's world. The amendment of Companies Act especially aims to simplify the process of registration, operation and de-registration of companies. Furthermore, the Budget also envisions formulation of new intellectual property law and loan related law.

To align with the Budget's proposal for revising Nepal's Industrial and Investment laws, reforming the following aspects is crucial for enhancing the business and foreign investment environment:

1. **Foreign Investment and Technology Transfer Act 2019 and it's Regulations**

(a) Simplify Repatriation Process: The FITTA mandates dual approval from the DOI and NRB for foreign investors to repatriate earnings, share investments, and other funds. Eliminating the DOI's involvement and streamlining documentation could expedite the repatriation process, making Nepal a more appealing destination for foreign investors.

(b) Ease Restriction on Retail Business: The FITTA restricts FDI in the retail business. It is not possible for some industries to manufacture all products from its portfolio; some need to be imported and sold. The FITTA's schedule could be revised to allow manufacturing industries with foreign investment to domestically sell and distribute a portion of the retail goods they import from their foreign parent companies.

(c) Revise the definition of Technology Transfer and revise the threshold on fees for Technology Transfer: The FITTA defines Technology Transfer as any transfer of technology to be made under an agreement between an industry and a foreign investor on, among others, patent, design, trademark, goodwill, technological specificity, formula, management and marketing service. Although the parent legislation FITTA only imposes a 5% cap on royalty for the liquor industry, the FITTR imposes royalty cap on all Technology Transfer businesses where the cap ranges from 5%-15% depending on sales made within or outside Nepal, which is contrary to the FITTA. The imposition of upper limit on these payments can be a hindrance to many companies in Nepal when they are unable to make timely payments due to exceeding the prescribed threshold.

As per WIPO, Technology Transfer (TT) is a collaborative process that allows scientific findings, knowledge and intellectual property to flow from creators to public and private users. Its goal is to transform inventions and scientific outcomes into new products and services that benefit society. Businesses in Nepal could benefit if the scope of Technology Transfer got limited to technological know-how and excluded components like technical advisory, management and marketing services. The cap on fees of Technology Transfer extends to the aforementioned latter components by default, which can be a deterrent to foreign investors wishing to enter the Nepalese market.

2. **Industrial Enterprises Act 2020 and it's Regulations**

(a) Remove Approval for Increase of Capital and Capacity: IEA requires all industries to obtain prior approval of the DOI to increase capital and capacity of a company. In practice, this process is time consuming (on average 1-6 months). Removing approval requirements could expedite industrial operations.

3. Notice under Foreign Exchange (Regulation) Act 1962, and repeal of Act Restricting Investment Abroad 1964

(a) Enable Outward Foreign Investment: Liberalizing outward investments could enable Nepalese citizens to benefit from the returns generated by their overseas investments. To achieve this, repealing the Act Restricting Investment Abroad 1962 and issuing a notification under the Foreign Exchange (Regulation) Act 1962 that specifically permits outward investments in promising sectors like manufacturing and information technology would be necessary.

4. Hedging Rules 2022

(a) Forex Risk Sharing Mechanism and Establishment of Hedging Entity: Hedging regulation in Nepal was first enacted in 2075 (2019). This regulation got replaced by the Hedging Regulation, 2079 (2022). The principal purpose of the new hedging regulation is to attract foreign loans by mitigating foreign exchange currency risks. However, due to various ambiguous issues in the regulation and failure to establish a hedging entity, there is no project that has availed hedging facility. Hedging Regulation 2022 should be amended to provide clear foreign currency fluctuation risk sharing mechanism the establishment of Hedging Entity should be expedited.

5. Labor Act 2017

(a) Relax Restrictions on Hiring Foreign Workers: Nepal's competitiveness could be enhanced by allowing foreign-invested companies to hire more foreign workers with high skill sets. The Labor Act and it’s directives should be amended to increase the quota of foreign workers in Nepalese companies, and by streamlining the work permit and visa procedures.

6. Formulation of New Intellectual Property Law

(**a) The current industrial/intellectual property law is outdated in many aspects.** Patent Design and Trademark Act was enacted in 1965, and this Act has been revised a few times but still lacks many fundamental aspects of intellectual property protection. The Copyright Act is also old and lacks modernized approach to copyright protection and enforcement in the digital age. The existing laws are not powerful enough to address the issues related to intellectual property. For instance, there is no law governing the relationship between and among Industrial Property Section under Department of Industry ("DOI"), Custom Department and Police authorities. In case any IP owner (an individual or entity) files infringement suit at the DOI, the DOI itself will not initiate any formal process for the confiscation and additional required proceeding to penalize the act of infringement. The IP owner itself requires to file a separate application at the Custom office and concerned police authorities for enforcement of the judgement of the DOI.

Nepal is also party to TRIPS Agreement under which Nepal is mandated to create laws in compliance with the same. However, the current laws are not in compliance with the Agreement. For example, Nepal does not have clear provisions on protection of well-known trademarks, which has been outlined in the TRIPS Agreement. The laws should be thus revised and updated and with that, the amount of the punishment related to the infringement of intellectual property rights should be increased. Further, the prevailing intellectual property related laws shall be redrafted in compliance with the TRIPS Agreement

ii. Increment of Technology Transfer Fees Sent to Foreign Countries

The Budget proposes raising the threshold for Technology Transfer fees that can be sent abroad. This would require amendment of Annexure 1 of the Foreign Investment and Technology Transfer Rules 2021 (the "FITTR"). Although the parent legislation FITTA only imposes a 5% cap on royalty for the liquor industry, the FITTR imposes royalty cap on all businesses where the cap ranges from 5%-15% depending on sales made within or outside Nepal, which is contrary to the FITTA. An increase in the cap on technology transfer fees is likely to enhance the convenience of Nepalese entities engaged in the acquisition and timely payment of technology transfer to foreign parties.

iii. Reinvestment of Earnings from Technology Transfer in Foreign Countries

It is envisaged by the Budget that Nepalese be permitted to reinvest a portion of their retained earnings from technology transfers conducted abroad, subject to a specified limit. The latest amendment to FITTA authorizes Nepalese entities to undertake Technology Transfers abroad. The said amendment permits Nepalese industries to make Technology Transfer in foreign country's industries, firms or companies, and such Nepalese industries can establish Branch Offices in foreign countries to facilitate such Technology Transfers. A further amendment to the FITTR may be necessary to outline the procedure for opening Branch Office and reinvesting retained earnings in foreign countries. Additionally, the Act Restricting Investment Abroad 1964 may also need revision to enable outward investments because this law prohibits Nepalese citizens and investors from investing in a foreign country.

iv. Establishment of Investment Companies to Foster Business

The budget encourages establishment of investment companies by the private sector for collecting small capital to invest in various enterprises and infrastructure development for fostering the business environment of Nepal. The directives of Companies Act 2006 and Notice on Terms and Conditions, 2079 (the "Notice") published by the DOI require that the paid-up capital of an Investment Company be NPR 1 Arba.

The Notice also requires that investment companies invest in those sectors not restricted by the FITTA, and that such companies only make equity investment and refrain from investing in loan, debenture, and bond, among others.

To bring more ease in the investment activities, the requirements of Companies Act, its directives and the DOI published Notice may need to be relaxed. Investors may find it more appealing if (a) the paid-up capital of investment company gets reduced from NPR 1 arba, (b) the area of investment is opened to all sectors, and (c) restriction on types of investment is removed.

v. Guarantee of Policy Stability and Investment Security

Ensuring policy stability in Nepal requires a sustained period of political stability. A stable government can effectively implement policy decisions and foster investor confidence. For instance, previously, Nepalese businesses engaged in Business Process Outsourcing, Cloud Computing and similar Information Technology related services that earned revenue in foreign currency were taxed 1% of the Taxable Profit. But now as per the latest Fiscal Act, they will be charged at 50% of corporate tax i.e. 12.5% of the Taxable Profit. The frequent changes in tax thwarts investors from their business plans and anticipated activities.

vi. Credit Rating

Nepal's credit rating and reporting system suffers from a fragmented legal framework, hindering its effectiveness. Currently, no dedicated Act governs credit rating and reporting. Instead, scattered provisions reside in Byelaw 3 of the Nepal Rastra Bank (NRB) Credit Information Byelaws 2001, Directive No. 12 of the Unified Directives for Banking Financial Institutions (BFIs), the Nepal Rastra Bank Act 2002, and various NRB circulars.

Similarly, Nepal lacks sovereign rating. Sovereign rating allows investors to take first impression of macro environment of a country and further allows assessment of country risks. Sovereign rating is also important when it comes to issuing bonds and entering into capital markets in a foreign country. However, there is a lack of sovereign rating of Nepal by key rating agencies.
The Nepalese credit reporting system lacks many of the components of a comprehensive credit reporting system. The CIB of Nepal (KSKL) was initially established on 14 May 1989, under Nepal Bankers Association as a non-profit organization. The main objective of its incorporation was to provide vital credit information services to its member institutions, to allow them to make informed and objective credit decisions.

Although the Central Bank has initiated several regulatory reforms and established the KSKL, the Bureau's work mainly confines with keeping data and supplying them without any analytical review. There is no value addition and/ or transformation of data. Thus, the magnitude of service delivered by the Bureau does not align with the international best practices. For the last three decades, the Nepalese Banking sector has shared its information to the Bureau, but the information is limited to negative information.

Upgrading the credit rating/reporting law, and obtaining sovereign rating may boost Nepal's access to international financing and foreign bond market.

vii. Development of Double Tax Avoidance Agreement

The Budget envisions development of a model Double Tax Avoidance Agreement with the goal of increasing investment inflow from potential investment countries. Likewise, the Budget also targets initiating negotiations with potential countries based on that model. In a similar vein, the GON adopted a model Bilateral Investment Agreement (BIA) in April 2024. This model will serve as a template for future negotiations with other countries seeking to sign such agreements.

According to the Income Tax Act, 2002 (2058) and the Double Taxation Avoidance Agreement ("DTAA") between Nepal and other countries, non-residents of Nepal are only required to pay taxes if they have an income source within Nepal. However, Nepalese courts have taxed non-residents of Nepal, who are residents of the other State under the DTAA, on the grounds that they could claim tax credits in their home country. There are many such decisions from the courts of Nepal, in contrary to the DTAA. A potential solution to resolve this issue could be for the legislature to provide clearer provision.