What to Expect from Nepal's 2024/25 Budget and Finance Act: A Tax Law Analysis

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1. Digital Permanent Establishment

Amendment

The Finance Act, 2024 (2081) has amended the Income Tax Act, 2002 (2058) ("ITA"), introducing a new type of permanent establishment ("PE"). As per the amendment, a foreign entity will be considered to have a PE in Nepal if it (a) has a significant digital presence in Nepal, or (b) conducts transactions in Nepal involving data or services for at least 90 days within the last 12 months while keeping a server outside of Nepal ("Digital PE"). This has already come into effect as of 16 July 2024.

What's New and Who is Covered?

The concept of Digital PE is generally a new one, and Nepal is one of the few jurisdictions that have adopted it. It appears that the provision of taxing foreign digital service providers has been implemented in only 18 countries. This concept is a departure from the traditional view that a physical presence is mandatory to deem a foreign entity has a PE.

The scope of Digital PE remains unclear. The key phrases are "significant digital presence" and "transaction of data or services". The tax authorities have not yet formulated any guidelines on what constitutes a "significant digital presence" or a "transaction of data or services." In India, for instance, a non-resident entity is deemed to have a PE if it meets certain economic thresholds, such as payments exceeding annual NPR 32 million for data and software downloads, or engaging with at least 300,000 users. Similar to the digital service tax ("DST") (discussed below), which was implemented without necessary groundwork, the Digital PE concept may also suffer from low compliance unless the Inland Revenue Department ("IRD") provides necessary guidance.

Will Digital Service Tax Still Be Applicable?

Nepal has already implemented DST for non-resident digital service providers, effective from 17 July 2022. Digital service providers offering services to customers in Nepal and generating annual turnover exceeding NPR 2 million [revised to NPR 3 million by the new Finance Act, 2024 (2081)] must pay a 2% DST on their annual turnover. There is also an obligation to pay 13% VAT on the income earned from Nepal.

The issue now with the introduction of Digital PE is whether the DST should be discontinued. If not, there is a possibility that foreign digital service providers may be taxed twice for the same income and required to comply with both the DST law and ITA. The provision on DST states that the income taxed under DST law will not attract tax under the ITA. This should then at least mean that all foreign service providers who fall under Digital PE will not have to make separate tax payments under DST. The practical approach (even without amending any legal provisions) may be:

(a) service providers who fall under Digital PE (based on turnover/subscriber number criteria, which we recommend IRD should provide guidance) will only comply under ITA, and
(b) those who fall outside the scope of Digital PE will continue to comply with DST (provided the criteria of DST are fulfilled).

In India, there are clear provisions in the relevant laws which provide specific clarity on the similar issue that the same income is taxed only under one scope, i.e., either as PE or as equalization levy. Generally, but more particularly in tax legislation, the best way to ensure compliance is to provide greater clarity.

Compliance

As Digital PE falls under the ITA, entities must comply with its provisions, including obtaining a PAN Certificate, filing estimated returns, annual returns, and making tax payments in three installments. However, foreign entities might struggle to comply with these provisions without a bank account and physical presence in Nepal, challenging the digital nature of Digital PE. The IRD will need to treat Digital PE differently from traditional PE. Traditional PE requires a physical presence in Nepal, such as a workforce or agents. In contrast, Digital PE aims to encompass non-residents who have no physical presence in Nepal but engage digitally with the market.

DTAA

The government may wish to consider incorporating Digital PE in relation to future Double Taxation Avoidance Agreement ("DTAA") negotiations. It is unlikely that Digital PE will be applicable in relation to the 11 DTAAs Nepal currently has in place.

2. Change in Control

Existing Provision

Section 57 of the ITA is triggered if a transaction results in a change of 50% or more in a company's shareholding within three years. According to Section 57(1) of the ITA, after such a change, the entity is deemed to have disposed of its property and liabilities and must pay tax on any gain. Apart from taxation, when Section 57 is triggered, there are other implications such as restrictions on carrying forward the losses.

Amendment

The amendment exempts capital increases by adding new shareholders or partners without altering the number of shares or capital of existing shareholders or partners. This exemption is applicable only to the start-up, venture capital and private equity fund (**"Exempted Entities"**). This change should help Exempted Entities raise capital from new investors without affecting existing shareholders's stakes. This has already come into effect as of 16 July 2024.

Objective of Provision Like Section 57

The primary objective of provisions like Section 57 is to prevent tax abuse, specifically to stop companies from merging or acquiring another company solely to benefit from their losses, a practice known as trafficking in tax attributes. The goal of the change in control provision is as an anti-avoidance measure rather than a taxation tool.

Nepal's Practice

In Nepal, Section 57 functions more as a taxing provision rather than an anti-abuse law. Until the Finance Act, 2024 (2081), there were no exceptions to Section 57. As currently worded, Section 57's risk of applicability is in wide areas even when such transactions are (a) not for trafficking of tax attributes, (b) not done for efficiency purposes, for example, group restructuring, or (c) changes happening by operation of law like insolvency or death in a family member. The changes will definitely help in situations of fundraising and should address some of the current issues. This change, however, has its own limitations on fundraising as well. The key requirement for the applicability of the amendment is that the existing shareholders should hold the same number of shares and the same capital. The reality of fundraising may be different: a company having shareholders A and B may want to raise funds from C in such a way that new funding will be contributed by C along with A but not B. This capital injection will not fall under the new exemption and therefore the exception lacks the real understanding of similar provisions of change in control in other jurisdictions.

We need to learn from other jurisdictions. There are various ways to design it. Given that there already is capital gain tax on sellers under Section 95A, a good approach would have been to provide an exception to Section 57 on a "business continuity test", i.e., if the entity continues to conduct the same business for a period of 24 months, then there will be no implication of Section 57. This is only fair. If we want to design Section 57 for the collection of offshore share transfers, then in the case of offshore transfers, Section 57 can be used for the collection of taxes but without affecting an entity's ability to carry forward losses.

As stated above, introducing a business continuity test would help distinguish legitimate transactions from abusive schemes. Many countries, including Tanzania, Saudi Arabia, Canada, New Zealand, Singapore, Germany, and Australia, offer exceptions such as the business continuity test allowing provisions like Section 57 to apply only if the entity fails this test.

Interpretational Issue of the Amendment

- <u>Scope of Exempted Entities</u>

The definition of a start-up is not explicitly provided in the ITA, although it is outlined in other laws, such as the Industrial Enterprise Act, 2020 (2076). Section 11(3t) of the ITA, introduced three years ago, provides certain tax exemptions for start-ups that utilize new and innovative knowledge, ideas, and skills, with annual transactions of up to NPR 10 million, as prescribed by the IRD. However, the IRD has not yet provided any guidance on this, leading to issues in implementing the exemption. Furthermore, venture capital and private equity funds are not defined in the ITA but are defined by SEBON in its Specialised Investment Fund Regulation 2019. It is not clear whether the reference to venture capital and private equity funds in the ITA is to the SEBON registered specialised investment funds or includes all categories of PE/VCs operating in Nepal. Therefore, the IRD should provide clear definitions of the Exempted Entities aligning with other laws and offer clarity for the effective implementation of the amendment.

- <u>Offshore Transaction</u>

In the landmark Ncell case, the Supreme Court ruled that Section 57 applies to indirect offshore transactions, even if the Nepalese company's shares are not directly disposed of. This decision was based on the shareholder of the Nepalese company being an interposed entity with no independent business activity. It may raise interpretational issues about whether Section 57 will be triggered if the offshore shareholder raises capital from new investors without changing the existing shareholders' shares and capital. The logical interpretation should be that the exception applies in those cases as well.

3. Tax Immunity

Exemption in Past

Historically, some Finance Acts have provided exemptions from paying interest, fees, and taxes if the tax under certain sections had not been paid. Some Finance Acts in the past have provided exemptions on interest and fees to businesses or professionals in certain sectors who had not paid taxes or fees.

Current Exemption

This year's Finance Act, 2024 (2081) offers exemptions to (a) individuals not previously in the tax bracket and (b) taxpayers who failed to submit returns. If an individual, who previously earned taxable income but did not pay taxes, pays tax for fiscal years 2078/79 and 2079/80, they are exempted from interest, fees, and charges for the said fiscal years. They are also exempted from the tax, interest, fees, and charges for fiscal years before 2078/79. Similarly, taxpayers who failed to submit returns can pay the due tax by March 13, 2025, along with 25% of the interest, to be exempted from remaining fees and interest. This has already come into effect as of 28 May 2024.

The tax immunity provisions would have been more welcomed if they were designed for past Section 57 non-compliances as well. When Section 57 is triggered, a company should prepare separate accounts for periods before and after the ownership change and file two separate returns. Entities that failed to file two returns but filed a single return should technically benefit from the above exemptions. This is because they failed to file two returns as required by the law. If assessed by the tax authorities, they would be fined for non-compliance. However, the tax authorities' view seems to be that the exemption doesn't apply to such entities, interpreting that such entities did file returns for the entire fiscal year, even though they did not segregate the fiscal year and make two filings as required by the law.

Recommendation

The government and tax authorities must consider who should benefit from such exemptions: (a) regular taxpayers who missed filing under Section 57 due to interpretational issues, (b) those who never filed returns, or (c) both. Providing exemptions to taxpayers who never paid taxes but not to taxpayers who underwent a change in control but failed to file returns due to various reasons might be unfair.

4. Rent Tax

Issue with Rent Tax

There's an ongoing issue about where rent tax should be deposited: local authorities or the federal tax office. The federal office argues that rent tax from entities should be paid to it, while rent from natural persons should go to local authorities. Local authorities, like Kathmandu and Biratnagar Metropolitan Cities, claim all rent tax should be paid to them, regardless of the lessor's nature.

Reason for the Issue

The issue arises from the Constitution of Nepal, 2015 (2072), which grants the federal government the power to collect corporate income tax and local authorities the power to collect house rent tax. The Intergovernmental Finance Management Act, 2076 (2074) supports these provisions. The federal tax authority argues rent from entities falls under corporate income tax, while local authorities argue all rent tax falls under their jurisdiction.

Recommendation of HLTR Committee

A recent High-Level Tax Reform Committee report recommended amending the law to require all house rent tax to be paid to the federal level, regardless of the lessor's nature. The new budget for fiscal year 2024/25 (2081/82) supports implementing this report and removing overlapping powers and jurisdictions of federal, provincial, and local levels.

Additional Issue and Recommendation

Taxpayers likely don't care which authority they pay rent tax to; the importance is how much of the tax they need to pay. The current dispute risks double taxation, as paying rent tax only to one authority could result in penalties from the other. If taxpayers pay the tax only to the federal level and not to the local level, they are not registered for local business tax by the local authorities, and when they eventually register, they will owe local business tax plus interest, as well as the rent tax plus interest to local authorities. Conversely, if they pay only to the local level and not to the federal level, they still owe rent tax plus fines and interest to the federal authorities. Therefore, if policymakers intend to implement the new budget provisions, they also need to address past non-compliance due to the dispute between federal and local tax authorities.

5. Tax Assessment

Practice in Nepal

Nepal's income tax and VAT systems operate on a self-assessment basis, where taxpayers determine and pay their own taxes. The tax office can reassess and demand unpaid taxes if not correctly paid. In practice, there are many instances where the tax office makes incorrect assessments, even when tax provisions are clear. Challenging such assessments requires depositing 25% of the disputed tax with the IRD, and another 25% to contest in the Revenue Tribunal, deterring many taxpayers from pursuing justice.

Budget Policy

The new budget for fiscal year 2024/25 (2081/82) acknowledges taxpayer complaints and proposes addressing tax assessment issues. Given the technical nature of tax law, thorough training for tax officers is essential. Implementing a program to ensure tax officers can accurately handle complex assessments is recommended. Adopting practices from other countries where courts favor taxpayers when tax laws are unclear would enhance fairness and trust in the system.

6. VAT on Essential Consumable Items

The Finance Act, 2023 (2080) amended the VAT Act 1996 (2052), imposing a 13% VAT on potatoes, onions, and apples. This decision faced public criticism. The Finance Act, 2024 (2081) removed the VAT on these items. This is one of many instances where the government has imposed and then removed tax on items without any detailed study and clear rationale behind the tax rates. [Note: This has already come into effect as of 28 May 2024.]

7. Other Key Changes

(a) Tax on Interest: The Finance Act, 2024 (2081), has reduced the withholding rate on interest payments by local banks and financial institutions to foreign banks or financial institutions from 10% to 5%. This will certainly assist local banks in raising funds that can be used in the infrastructure sector. The next phase of infrastructure development may mean that international bond markets may have to be accessed. As a next reform, tax exemption (for qualifying thematic bonds like green bonds) or a reduced tax rate similar to 5% can be considered.

(b) VAT Threshold: The threshold for VAT registration has been increased from NPR 2 million to NPR 3 million in annual turnover for businesses dealing in services or both goods and services.

(c) DST Threshold: The threshold for PAN registration by foreign digital service providers has been increased from NPR 2 million to NPR 3 million in annual turnover.