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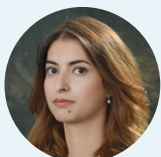


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A commentary on the Budget Speech 24/25 from the perspective of Private Equity and Venture Capital Industry

With a decade-long history, the private equity and venture capital (PE/VC) industry in Nepal has made significant strides, marked by the recent establishment of 8 SEBON-Licensed specialized investment funds ("SIFs") supported by local investors. With NPR 45 billion expected to be added by the SIFs alone, the total fund size of Nepali and Nepal focused PE/VCs is estimated to be more than NPR 65 billion. While this growth has been significant in providing alternative capital to Nepali businesses it has also highlighted numerous regulatory challenges that need to be addressed to further develop the PE industry. The PE community currently awaits regulatory reforms to ease fund-raising, fund operation and exit.

On 28 May 2023, the Honorable Finance Minister, Mr. Barsa Man Pun, presented the budget for the fiscal year 2024-2025 (2081-82 BS). The government has set a budget ceiling of NPR 1.8 trillion, reflecting a significant commitment to economic growth and development. The budget speech emphasized the need to encourage investments, particularly in the private sector, to boost the economy as one of its five priority areas. Among the many reforms awaited by the PE industry, the budget speech covered only two issues, namely fund-raising and change-in-control taxation.

Fund Raising for SIFs

Eligible Investors: The SIF Regulation 2019 outlined a broad definition of 'eligible' investors to encourage investment in SIFs. This investor category included banks, financial institutions, insurance companies, employee provident funds, citizen investment funds, foreign individuals and entities, non-resident Nepalis, among others. Despite this inclusive approach, only a few of these investor categories have invested in SIFs. The primary reason is that the SIF Regulation alone could not modify the investment mandates and procedures for these eligible investors, necessitating amendments to the laws governing each of these investor types. This gap was closed for insurance and reinsurance companies when their relevant investment guidelines were amended in 21 December 2023 to permit investment in SIFs.



In an effort to encourage investment into PE/VCs, including SIFs—the Budget Speech, in paragraph 90, mentions that arrangements will be made for various contractual funds to invest in security units of PE/VC. While 'contractual fund' is not a term referred in any legislation, we understand the reference may be in relation to contractual savings institutions like employee provident funds, citizen investment funds, insurance companies etc.

To fully realize the intention outlined in the Budget Speech, cohesive and supportive amendments to the investment mandates of each contractual savings institution will be necessary.

Foreign Investors: PE/VCs have not been able to raise funds from outside Nepal due to the lack of legislative clarity regarding foreign investment in SIFs. The Foreign Investment and Technology Transfer Act 2019 (FITTA) is the primary legislation regulating foreign investment in Nepal. FITTA deals with investment in "shares" in 'companies'. The SIF Regulation has envisioned SIFs as unincorporated schemes similar to mutual funds, which do not have a legal vehicle. Since SIFs are neither companies nor industries, they remain outside the scope of FITTA. Given investments "units" does not currently fall within the scope of FITTA, a better approach may be to allow foreign investors to invest in the units with SEBON's approval and repatriation facility to be provided with approval of the Central Bank. This approach will provide much needed clarity and instill confidence in this growing sector.

Taxation Issues for PE/VCs

Another key issue addressed by the Budget Speech, followed by an amendment proposed in the Finance Bill 2024, pertains to the 'Change in Control' tax under Section 57 of the Income Tax Act 2002. The Change in Control tax was levied on any company whose ownership had undergone change of 50% or more within a period of three years. Upon such a change in control, the company was regarded as having disposed of its assets and liabilities, which were evaluated at market price. The company was then required to pay a tax of 25% on any gain arising from this deemed disposal of assets and liabilities. Additionally, the company would be barred from carrying forward any losses recorded in its books.

This provision under the Income Tax Act has posed a significant challenge for the PE/VC ecosystem, as companies receiving funding from PE/VC often raise multiple rounds of funding, experiencing several entries and exits from various investors. This exposed such companies to additional tax liabilities and hindered their ability to adjust losses (losses being very common feature in most of startups) due to changes in ownership structure—a natural consequence of fundraising.

The Budget Speech and the Finance Bill 2024 have proposed an amendment to the problematic Section 57. The amendment stipulates that the Change in Control tax will not apply when a company issues new shares to increase capital by adding new shareholders without altering the number of shares or capital of existing shareholders. This amendment has been positively received by the PE/VC ecosystem, as it would reduce the tax burden associated with a company's fundraising activities.

While the reform in the Change in Control tax will be a significant relief to the PE/VC ecosystem, this currently only address the entry issues (as entry is commonly done by issuance of new shares) and does not deal with the exit specially non IPO exit like sponsors buyback, trade sale. The PE/VC sector still will benefit from further reforms on taxes and VAT:



- **Application of Value Added Tax on the Services of SIF Fund Managers:** The VAT Act of 1996 stipulates that services related to securities, merchant banking, and similar activities are exempt from VAT. However, since SIF fund managers are not explicitly included in this list, it remains uncertain whether they qualify for a VAT exemption.
- **Tax Pass-Through:** Currently, PE/VCs in Nepal do not enjoy tax pass-through status, which is a common practice globally in the sector. Consequently, returns from the sale of a portfolio company are taxed at multiple levels, rendering indirect investments in businesses via PE/VC funds unattractive to fund-level investors. The Income Tax Act of 2002 provides a pass-through approach to mutual funds. Section 52(1) stipulates that the beneficiary and the entity shall be responsible separately for tax purposes. An amendment to Section 52 of the Income Tax Act to pass-through tax treatment to PE/VCs, like mutual funds, could encourage investment and create a supportive economic growth environment. From legal point of view, SIF and Mutual Fund shares the same characteristics i.e. both are collective investment schemes and unincorporated funds. There are no possible policy issues for extending same tax treatment to SIF as provided to Mutual Funds.

Other Key Reform Agendas for Enhancing the PE/VC Industry in Nepal

In addition to the aforementioned tax issues, the following matters is in the list of top 3 reforms in our list to enhance the Nepali PE/VC industry:

1. Debt Investment Guidelines for SIFs:

SEBON should prescribe the quantum of debt investment permitted for SIFs. The first amendment to the SIF Regulation on 16 July 2020 opened the avenue for SIFs to invest in debt instruments. However, SEBON has yet to issue any notice regarding this, preventing SIFs from incorporating low-risk, short-term debt instruments into their investment portfolios alongside equity investments.

2. Blacklisting Directive Exemptions:

Through various amendments to its Blacklisting Directive, NRB has exempted foreign investors, including offshore PE/VCs and onshore PE/VCs that invest in small and medium-sized industries and have more than 50% foreign investment. NRB should amend its Blacklisting Directive to provide a level playing field for all PE/VCs, including SIFs, to prevent blacklisting and encourage PE/VC investment in businesses with varying degrees of risk.

3. Recognition of Fund Management Companies:

Fund management companies should be recognized as a service-based industry under the Industrial Enterprises Act 2020. Currently, there is no appropriate industry category for registering a fund management company, leading them to be registered under 'technical consulting industry.' This misclassification inadvertently could place a maximum 51% cap on FDI in fund management companies, discouraging foreign investors who wish to establish a 100% foreign-owned PE/VC firm in Nepal.

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