Policy Brief

Equity, Debt and Tax Implication for Investments Made in Nepali Banks and Financial Institutions by Development Finance Institutions

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TABLE OF ABBREVIATIONS

ADB	Asian Development Bank
BAFIA	Banks and Financial Institutions Act, 2015 (2073)
BFIs	Banks and Financial Institutions
CGT	Capital Gains Tax
DFIs	Development Finance Institutions
DTAA	Double Taxation Avoidance Agreement
FERA	Foreign Exchange (Regulation) Act, 1962 (2019)
FITTA	Foreign Investment and Transfer of Technology Act, 2019 (2075)
GON	Government of Nepal
IFC	International Finance Corporation
ITA	Income Tax Act, 2002 (2058)
ITR	Incomes Tax Rules, 2002 (2059)
LIBOR	London Interbank Offered Rate
LPR	Loan Prime Rate
MCLR	Marginal Cost of Funds based Lending Rate
NEPSE	Nepal Stock Exchange
NPR	Nepali Rupees
NRB	Nepal Rastra Bank
ROFR	Right of First Refusal
SARON	Swiss Average Rate Overnight
SDG	Sustainable Development Goals
SEBON	Securities Board of Nepal
SOFR	Secured Overnight Financing Rate
SONIA	Sterling Overnight Interbank Average Rate
TONIA	Tokyo Overnight Average Rate
ESTER	Euro Short-Term Rate

SUMMARY

Key Regulatory Provisions with regards to Debt and Equity Financing and Taxes

This summary highlights, only those provisions that either need further clarification or need to be established since the regulations are silent on the matter. The provisions listed here under refers specifically to provisions that have impact on DFI investment in Nepali BFIs, in the form of (i) debt financing; and (ii) equity investment; and (iii) relevant tax implications on the investments (debt and equity).

1. IN CASE OF DEBT FINANCING

1.1 Variable Interest Rate

The NRB bylaws allows the use of Benchmark Interest Rate[1], but does not envisage whether the BFIs can use the term Benchmark Interest Rate or Compounded Benchmark Interest Rate.

This could be further clarified, particularly the use of compounded benchmark interest rate.

1.2 Fixed Interest Rate

A loan can also be provided with a fixed interest rate. Fixed interest rates are effective only for two (2) years and shall be revised every two (2) years with prior approval of NRB.[2]

The two-year prior approval requirement under this provision is cumbersome when the loan is for a longer tenure.

1.3 Adjustment of interest rate and fees

The NRB bylaws has allowed DFIs to impose following costs to the borrower beyond the interest rate ceiling: (i) tax, (ii) default interest at the maximum rate of 2%, (iii) prepayment fee at maximum rate of 0.25%, (iv) commitment fee at the maximum rate of 0.25%.

The NRB bylaws does not allow the adjustment of above-mentioned fees even when the interest rate and the fees are within the ceiling (benchmark + 4.5%) required by the NRB bylaws.

1.4 Payment before disbursement

The NRB bylaws allows the borrower to make payments to the foreign BFIs only after the first disbursement has been made.[3] Third-party payment and commitment fees cannot be made prior to first disbursement.

However, the borrower cannot make payment before the first disbursement in accordance with the provision of the NRB bylaws. This restriction is not consistent with international market practices found in other South Asian countries such as India and Bangladesh.

1.5 Restriction to impose penal interest on defaulted fees

Foreign BFIs can only charge penal interest on defaulted principal and interest amounts. It cannot further impose penal interest on defaulted fees and other associated cost of borrowings. However, such practice is inconsistent with the present international norms.

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1 Under the heading of Benchmark Interest Rate of Annexure 10 of the Nepal Rastra Bank Foreign Investment and Loan Management bylaws, 2021.

2 Condition No. 10 provided under Other Conditions of Annexure 10 of the Nepal Rastra Bank Foreign Investment and Loan Management bylaws, 2021.

3 Condition No. 8 provided under Other Conditions of Annexure 10 of the Nepal Rastra Bank Foreign Investment and Loan Management bylaws, 2021.

2. IN CASE OF EQUITY INVESTMENT

2.1. Minimum investment requirement

As per the Licensing Policy, a foreign BFI investing at the time of incorporation of a new BFI must invest at least 20% of paid-up capital (the "**Minimum Threshold**"). The maximum cap of such foreign equity investment is 85% of the promoter's share of paid-up capital.

This provision is however not explicitly clear whether it is applicable while investing via Share Purchase of existing Nepali BFIs.

2.2 In case of entry

2.2.1 *Modality for Share Purchase (Promoter)*

The current regulations do not explicitly provision for a foreign BFIs interested in equity investment in a Nepali BFI to adopt the share purchase modality.

If a foreign BFI were to invest in a Nepali BFI by Share Purchase mode, the existing promoter shareholder (the "**Selling Promoter**") would need to collectively offer at least 20% stake to start with. If not, there are no guidelines with regards to the modality.

2.2.2 *Right of First Refusal (ROFR)*

As per the NRB Directives, a promoter (or promoters together) must firstly provide a ROFR notice to other existing promoter shareholders.[4] Only after the other promoters waive their right or fail to purchase the shares within the timeline offered as part of ROFR, can a promoter offer the shares to a third-party buyer.

The mechanism for such transactions is not explicit and needs further clarification.

2.2.3 *Investment in more than one Nepali BFI*

The NRB Licensing Policy does not allow a local person or institution to own more than 15% holding in one BFI and more than 1% holding in another BFI, when they already hold 15% in another.[5]

It is unclear whether this provision is applicable to a foreign BFI.

2.3 In case of exit

2.3.1 *Lock-in period*

The NRB regulations do not specify whether foreign BFIs investing through Share Purchase or Share Subscription will have any lock-in period in the Nepali BFI.

2.3.2 *Full exit or partial exit*

Neither the NRB Licensing Policy nor the NRB Directives explicitly prescribe whether a foreign BFI invested in a Nepali BFI can make partial exits.

It is also unclear whether a foreign BFI will need to continue to hold the minimum 20% holding or whether it can start divesting and make partial exits over a period of time.

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4 Section 2(b) & 2(c), NRB Directive No. 10/079

5 Section 9.4, NRB Licensing Policy

6 Section 2(d), NRB Directive No. 10/079

2.3.3 *ROFR at the time of exit*

It is unclear from the regulations whether first right to refusal is essential for foreign BFIs at the time of exit.

2.3.4 *Pricing*

If a foreign BFI purchases shares from promoter shareholders, it will also be regarded as a promoter shareholder.[6] Shares held by promoter shareholders are listed with Nepal Stock Exchange ("**NEPSE**") similar to public shares. The listed price of public shares in NEPSE is generally taken as a basis for exit valuation of shares.

The NRB regulations however do not provide a guideline on pricing of promoter shares.

2.4 In case of Share Subscription in an existing Nepali BFI

The NRB Licensing Policy does not explicitly mention whether the minimum threshold of 20% is also applicable while investing via Share Subscription in an existing BFI. If a foreign BFI can subscribe to new shares if an existing Nepali BFI, (i) does the minimum threshold apply and (ii) will the Nepali BFI need to issue share to public to maintain the promoter public ratio of 51:49%.

2.5 In case of issuance of Right Shares

When the Nepali BFI issues Right Shares, is the foreign BFI compelled to subscribe to maintain the minimum threshold?

The NRB regulations needs to explicitly state whether such pre-emptive rights are to be exhausted in case of foreign BFIs investing in a Nepali BFI.

2.6 Maintenance of minimum threshold

The NRB regulation is unclear on how long a foreign BFI investing in a Nepali BFI needs to maintain its 20% minimum holding threshold.

This is also related to the lock in period of equity investment in Nepali BFIs.

3. IN CASE OF TAX PROVISIONS

3.1 Withholding tax

Section 88(1) of the Income Tax Act (ITA) of Nepal (2002) requires to withhold 15% tax while making payment of interest and fees. In relation to the interest payment by Nepali BFIs to foreign BFIs, including DFIs, the withholding tax rate is currently 10%, pursuant to Proviso “9” under Section 88(1) of the ITA.

This distinction between Multilateral Financial Institutions and Development Financial Institutions with similar goals and objectives creates an unlevel playing field even when DFI investments aim to achieve similar goals.

CHAPTER 1

Foreign Investment in Nepali BFIs

1.1 General background of Nepali BFIs

Nepali BFIs are incorporated as a public company under the Companies Act, 2006 (2063) and are licensed by the Central Bank, Nepal Rastra Bank ("**NRB**") under Banks and Financial Institutions Act, 2006 (2063) ("**BAFIA**"). NRB is the primary regulatory authority of the BFIs, which is a statutory body under NRB Act, 2058 (2002). BAFIA envisages five classes of BFIs in Nepal:

	Classes of BFIs	Names of Each Class of BFIs	No. of BFI[7]
1	A Class	Commercial Banks	21
2	B Class	Development Banks	17
3	C Class	Finance Companies	17
4	D Class	Microfinance Institutions	64
5	Infrastructure Development Bank		1

1.2 Foreign investment in Nepali BFIs

Foreign investment in the form of equity and debt is permissible in Nepali BFIs. The general FDI regime applicable to Nepali companies/industries does not apply to foreign investment in BFIs.[8] Foreign investment in BFIs is separately governed by BAFIA, FERA, and NRB regulations.

a) Pursuant to the NRB bylaws of May 2021, all Nepali BFIs are eligible to obtain debt from foreign BFIs.

Initially, only Class 'A' Commercial Banks were permitted, which has since been expanded. The table below provides a brief background on the inclusion of other categories.

	Eligible Borrower	NRB Circular
1	Class 'A' Commercial Banks	8 August 2018
2	Class 'D' Micro Finance	10 September 2018
3	Class 'B' Development Banks, and Class 'C' Finance Companies	27 February 2019
4	All Nepali BFIs and Infrastructure Development Bank	NRB bylaws dated May 31, 2021

7 PLA Note: The given link provides NRB Report on the total number of existing Nepali BFIs https://www.nrb.org.np/contents/uploads/2023/02/List-of-BFIs-Poush-2079-English.pdf. The report provides that there are 22 Class "A" commercial banks. However, due to recent merger and acquisition of commercial banks, the total number of Class "A" commercial banks has reduced to 21.

8 This is because FITTA regime is only applicable to industries established under the Industrial Enterprises Act, 2020 (2076) and BFIs do not fall under IEA.

1.2.1 Debt investment

a) The primary legislations governing debt investment by DFIs are – (a) Foreign Exchange (Regulation) Act, 1962 (2019) ("**FERA**") and (b) NRB bylaws.

b) The following table gives a brief background on the evolution of eligible lenders to lend to Nepali BFIs:

	Eligible Borrower	Eligible Lender	NRB Circular
1	Class 'A' Commercial Bank	Indian BFIs	8 August 2018
2	Class 'D' Micro Finances	Foreign BFIs or other institutions	10 September 2018
3	Class 'A' Commercial Bank, Class 'B' Development Bank and Class 'C' Finance Companies	Foreign BFIs and institutions such as pension funds and hedge funds, which have obtained approval to grant foreign loan from their regulating authorities	9 September 2019
4	Class 'D' Micro Finance	Foreign BFIs and institutions such as pension funds and hedge funds which have obtained approval to grant foreign loan from their regulating authorities.	9 September 2019

c) As of January 2023, 10 Commercial Banks have foreign borrowings (1) NMB, 2) Sanima, 3) Siddhartha, 4) Laxmi, 5) Global IME, 6) Machhapuchhre, 7) Everest, 8) Sunrise, 9) Nepal SBI and 10) NIMB).[9]

1.2.2 Equity investment

a) The key legislations governing equity investment in Nepali BFIs are: (i) BAFIA, (ii) Nepal Rastra Bank Foreign Investment and Loan Management bylaws, 2021 (2078) ("**NRB bylaws**"), (iii) Directive No. 10/079 issued by Nepal Rastra Bank (the "**NRB Directive**"); (iv) NRB Licensing Policy, 2006 (2063) ("**NRB Licensing Policy**"); and (e) Securities Act, 2006 (2063).

b) Pursuant to BAFIA, only "foreign BFIs" are eligible foreign investors for equity investment in Nepali BFIs.[10]

c) As per the NRB report of mid-March 2022, 12 foreign BFIs have made equity investment in Nepali commercial banks.[11] However, the latest standings show that there are six Nepali Commercial Banks with foreign BFI equity investment – 1) Standard Chartered, 2) NABIL, 3) Nepal SBI, 4) Himalayan, 5) NMB, and 6) Everest.[12]

9 Based on the latest annual reports for FY 2078/79 (FY 2022/23) of all existing commercial banks available in their respective websites, we identified that 10 commercial banks have foreign borrowings.

10 Section 5, BAFIA

11 https://www.nrb.org.np/contents/uploads/2022/04/Optimal-Number-of-Banks-and-Financial-Institutions-in-Nepal.pdf.

12 Based on the latest annual reports for FY 2078/79 (FY 2022/23) of all existing commercial banks available in their respective websites, we identified that 6 commercial banks have foreign equity investment.

CHAPTER 2

Debt Financing by foreign BFIs in Nepali BFIs

2.1 Background on debt financing in Nepali BFIs

2.1.1 *Approval and recording regulation*

The foreign loan facility is regulated by NRB on an approval basis. All Nepali BFIs require written approval from NRB to accept debt financing from foreign BFIs.

The NRB bylaws under Schedule-11 has provided a list of documents to be submitted to NRB for obtaining approval in case of debt financing by foreign BFIs.

After the foreign loan is received in Nepal, the Nepali BFI is required to record the same with NRB and get a repayment schedule approved from NRB. It should be completed within six months from the date of receiving such loan. A repayment schedule can also be approved while applying for the loan approval from NRB.

2.1.2 *Sectors for utilization and restriction*

The NRB bylaws[13] permits Nepali BFIs to utilize such loans obtained from foreign BFIs only in the permitted sectors; (i) energy, (ii) infrastructure, (iii) tourism, (iv) agriculture, and (v) micro enterprise.

The NRB bylaws prohibits Nepali BFIs from utilizing the foreign loans to: (i) the real estate sector including housing, and development, (ii) share pledge loan, (iii) inter-banking foreign currency transactions and (iv) investment in investment instruments.[14]

2.1.3 *Limitation on the loan amount*

According to the NRB bylaws, a Nepali BFI can now raise foreign loans up to 100% of its core capital.[15] This limitation is inclusive of any and all loans obtained in foreign currencies.

The following table illustrates how limitations on loan amounts were increased to the current 100% of core capital:

	BFIs	Limitation	NRB Circular
1	Class 'A' Commercial Bank	25% of core capital	8 August 2018
2	Class 'D' Micro Finance	25% of core capital	10 September 2018
3	Class 'A' Commercial Bank	50% of core capital	25 December 2018
4	Class 'D' Micro Finance	No limitation	31 January 2019
5	Class 'A' Commercial Bank, Class 'B' Development Bank and Class 'C' Finance Company	100% of core capital	27 February 2019
6	Class 'D' Micro Finance	No limitation	9 September 2019
7	All Nepali BFIs and Infrastructure Development Bank	100% of core capital	NRB bylaws dated May 31, 2021

13 Serial No. 7 within the table provided under Annexure 10 of the Nepal Rastra Bank Foreign Investment and Loan Management bylaws, 2021.

14 Serial No. 7 within the table provided under Annexure 10 of the Nepal Rastra Bank Foreign Investment and Loan Management bylaws, 2021.

15 Serial No. 7 within the table provided under Annexure 10 of the Nepal Rastra Bank Foreign Investment and Loan Management bylaws, 2021.

2.1.4 Repayment

Currently, the principal, interest and fees as approved by NRB (while obtaining the loan approval) can be paid to foreign BFI without a separate approval of NRB. In case of unapproved fees, a separate approval of NRB is required.

Before May 31, 2021, i.e., prior enactment of the NRB bylaws, the borrower was required to take NRB approval each time before making repayment to the foreign BFIs.

2.1.5 Repayment period

As per the S.N. 7 of Schedule 10 of the NRB bylaws, the repayment period shall be a minimum six (6) months to a maximum 15 years.[16] The loan can only be renewed with prior written approval of NRB. Before enactment of the NRB bylaws, meaning prior May 31, 2021, the repayment period was required to be between one to five years.

2.1.6 Interest rate

The NRB bylaws categories interest rates in three categories as follows:

a. *Floating interest rate*

In case of floating interest, the ceiling for interbank lending is - one Year Benchmark Interest Rate + 4.5% p.a.[17] As per the NRB bylaws,[18] the Benchmark Interest Rate includes different benchmarks based on the loan denomination, as follows i.e., Secured Overnight Financing Rate (SOFR) for USD denominating loan facility, Sterling Overnight Interbank Average Rate (SONIA) for GBP denominating loan facility, Swiss Average Rate Overnight (SARON) in case of GHF based lending, Tokyo Overnight Average Rate (TONA) applicable for JPY, and Euro Short-term Rate (€STER) for Euro denominated loan.

b. *Fixed interest rate*

A loan can also be provided with a fixed interest rate. Fixed interest rates are effective only for two (2) years and shall be revised every two (2) years with prior approval of NRB.[19]

c. *NPR denominated loan*

Foreign BFIs can also lend in NPR denominated loans to Nepali BFIs with the loan being remitted in foreign currency.[20] In such case, the foreign exchange risk shall be borne by the foreign BFI. The maximum interest rate allowed for such loan shall not exceed the average base rate of the Nepali commercial banks. This rate is published by NRB in the document titled "Current Macroeconomic and Financial Situation of Nepal". NRB publishes the average base rate of Nepali commercial banks on a monthly basis.

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16 Serial No. 7 within the table provided under Annexure 10 of the Nepal Rastra Bank Foreign Investment and Loan Management bylaws, 2021.

17 Serial No. 7 within the table provided under Annexure 10 of the Nepal Rastra Bank Foreign Investment and Loan Management bylaws, 2021.

18 Under the heading of Benchmark Interest Rate of Annexure 10 of the Nepal Rastra Bank Foreign Investment and Loan Management bylaws, 2021.

19 Condition No. 10 provided under Other Conditions of Annexure 10 of the Nepal Rastra Bank Foreign Investment and Loan Management bylaws, 2021.

20 Condition No. 9 provided under Other Conditions of Annexure 10 of the Nepal Rastra Bank Foreign Investment and Loan Management bylaws, 2021.

21 Condition No. 8 provided under Other Conditions of Annexure 10 of the Nepal Rastra Bank Foreign Investment and Loan Management bylaws, 2021.

The interest rate as provided above does not include following cost of borrowing:[21]

a) applicable tax on loan financing as per prevailing tax laws of Nepal;

b) default interest rate of up to 2% p.a., which is imposed on defaulted principal and interest;

c) prepayment fee of up to 0.25% of the principal amount; and

d) commitment fee of lumpsum up to 0.25% p.a.

The history of interest rate ceilings issued by NRB is as follows:

	Borrower	Interest Rate Ceiling	NRB Circular
1	Class 'A' Commercial Banks	MCLR + 1% p.a.	8 August 2018
2	Class 'D' Micro Finance	6 Month LIBOR + 3%	10 September 2018
3	Class 'A' Commercial Banks	MCLR + 1% p.a.	15 December 2018
4	Class 'D' Micro Finance	6 Month LIBOR + 4%	9 September 2019
5	Class 'A' Commercial Banks	6 Month LIBOR + 4%	9 September 2019

The aforementioned ceiling is based on all-in-cost mechanism, where all the cost of borrowing was required to be within the said ceiling.

However, over the years, NRB has given approval to make payment of contingent fees over and beyond the prescribed interest rate ceiling.

2.1.7 *Payment before disbursement*

The NRB bylaws allows the borrower to make payments to the foreign BFIs only after the first disbursement has been made.[22] Third-party payments and commitment fees cannot be paid prior to first disbursement.

2.1.8 *Third party involvement and payment*

The NRB bylaws restricts the Nepali BFIs from making payments to a third-party.[23] If payments need to be made to third parties, such payments need to be made by the foreign BFIs and may recover such costs from the Nepali BFIs as in the form of cost of financing while complying with interest and fees thresholds.

22 Condition No. 8 provided under Other Conditions of Annexure 10 of the Nepal Rastra Bank Foreign Investment and Loan Management bylaws, 2021.

23 Condition No. 12 provided under Other Conditions of Annexure 10 of the Nepal Rastra Bank Foreign Investment and Loan Management bylaws, 2021.

CHAPTER 3

Equity Investment by DFIs in Nepali BFIs

3.1 A brief background of equity investment in Nepali BFIs

Nepali BFIs can issue two categories of shares, namely – (a) promoter shares, and (b) public shares pursuant to the NRB Licensing Policy. Promoter shares are allocated to the founders of the BFIs and their transferees,[24] while public shares are allocated to the public and employees of the BFIs. The minimum threshold of promoter shares in a BFI is 51% and public shares is 30% pursuant to the NRB Licensing Policy.

Foreign BFIs can only invest in the promoter shares category of BFIs pursuant to the NRB Licensing Policy. The minimum required investment is 20% and maximum 85% of the Nepali BFI's paid-up capital. They can do so by (a) subscribing new promoter shares issued by the BFI ("**Share Subscription**"), or (b) purchasing promoter shares from existing promoters ("**Share Purchase**") of the BFI.

3.1.1 Definition of foreign BFIs

Section 5 of BAFIA permits foreign BFIs to invest in Nepali BFIs as a joint venture with local investors. However, BAFIA does not define the term "foreign BFIs". It is unclear whether DFIs are included as foreign BFIs for the purpose of equity investment in Nepali BFIs.

3.1.2 Minimum investment requirement

As per the Licensing Policy, a foreign BFI investing at the time of incorporation of a new BFI must invest at least 20% of the paid-up capital (the "**minimum threshold**"). The maximum cap of such foreign equity investment is 85% of the paid-up capital.

This provision is however not explicitly clear if it is applicable while investing via Share Purchase of existing Nepali BFIs.

3.1.3 Issues at the time of entry

i) Modality for Share Purchase (Promoter)

The current regulations do not explicitly provision for a foreign BFI interested in equity investment in a Nepali BFI to adopt the share purchase modality.

If a foreign BFI were to invest in a Nepali BFI by Share Purchase mode, the existing promoter shareholder (the "**Selling Promoter**") would need to collectively offer at least 20% stake.

ii) Right of First Refusal (ROFR)

As per the NRB Directives, a promoter (or promoters together) must firstly provide a ROFR notice to other existing promoter shareholders.[25] Only after the other promoters waive their right or fail to purchase the shares within the timeline offered as part of ROFR, can a promoter offer the shares to a third-party buyer.

The mechanism for such transaction is not explicit and needs further clarification in case of a foreign BFI invested in a Nepali BFI.

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24 Transfer of promoter shares to new incoming shareholder will also categorize such incoming shareholder under the promoter shareholder category.

25 Section 2(b) & 2(c), NRB Directive No. 10/079

iii) Investment in more than one Nepali BFI

The NRB Licensing Policy does not allow a local person or institution to own more than 15% holding in one BFI and more than 1% holding in another BFI, if they already hold 15% in another.[26]

It is unclear whether this provision is applicable to a foreign BFI.

3.1.4 *Issues at the time of exit*

(A) Lock-in period

The NRB regulations do not specify whether DFIs investing through Share Purchase or Share Subscription will have to comply with lock-in period in the Nepali BFI.

- Full exit or partial exit

Neither the NRB Licensing Policy nor the NRB Directive explicitly prescribes whether a foreign BFI invested in a Nepali BFI can make partial exits.

It is also unclear whether a foreign BFI will need to continue to hold the minimum 20% holding or whether it can start divesting and make partial exits over a period of time.

- Pricing

If a foreign BFI purchases shares from promoter shareholders, it will also be regarded as a promoter shareholder.[27] Shares held by promoter shareholders are listed with Nepal Stock Exchange ("**NEPSE**") similar to public shares. The listed price of public shares in NEPSE is generally taken as a basis for exit valuation of shares.

However, the NRB regulations do not provide a guideline on pricing of promoter shares.

i) In case of Share Subscription in an existing Nepali BFI

The NRB Licensing Policy does not explicitly mention whether the minimum threshold of 20% is also applicable while investing via Share Subscription in an existing BFI. If a foreign BFI can subscribe to new shares in an existing Nepali BFI, (a) does the minimum threshold apply and (b) and will the Nepali BFI need to issue share to public to maintain the promoter public ratio of 51:49%.

ii) In case of issuance of Right Shares

When the Nepali BFI issues right shares, is the foreign BFI compelled to subscribe to maintain the minimum threshold.

The NRB regulations need to explicitly clarify whether such pre-emptive rights are to be exhausted in case of foreign BFIs.

iii) Maintenance of minimum threshold

The NRB regulation is unclear on how long a foreign BFI invested in a Nepali BFI needs to maintain its 20% minimum holding threshold.

26 Section 9.4, NRB Licensing Policy

27 Section 2(d), NRB Directive No.

CHAPTER 4

Tax

4.1 Overview of Tax Law in Nepal

Taxes in Nepal are divided into two categories: direct taxes and indirect taxes. Income earned or received from the business, investment, employment, and windfall gains are subject to direct tax. Indirect taxes are imposed on the value of goods and services. The primary laws regulating direct tax in Nepal are Income Tax Act, 2002 (2058) ("**ITA**"), and the rule made thereunder Income Tax Rule, 2059 (2002) ("**ITR**"). Primary laws regulating indirect tax in Nepal are Value Added Tax Act 2052 (1996) ("**VAT**"), Excise Duty Act 2059 (2002) ("**Excise Duty**"). The ITA follows the Nepali financial year. The Nepali financial year commences on mid-July of each year and ends on mid-July in subsequent year. All the audited accounts are kept as per the Nepali financial year. The corporate tax rate for BFIs is 30%.

4.2 Tax treatment on equity investment and debt financing

The tax treatment under ITA is subject to nature and source of income, and resident status of a person. The following are the applicable rates on income from foreign investment.

A. Equity investment

A foreign BFI investing in the form of equity in Nepali BFIs are subjected to two tax liabilities.

First, the foreign BFI is subject to 5% withholding tax while receiving dividend earned from the equity investment in the Nepali BFIs. The tax is deducted at source by the concerned BFI before making the dividend payment to the foreign BFI.

Second, the foreign BFI is subject to Capital Gain Tax ("**CGT**") if any income is derived from sales of equity shares at the time of exit. Non-exempted foreign BFIs are liable to pay 25% CGT on gains from the shares sold.

B. Debt financing

Section 88(1) of the ITA requires to withhold 15% tax while making payment of interest and fees. In relation to the interest payment by Nepali BFIs to foreign BFIs, the withholding tax rate is currently 10%, pursuant to Proviso "9" under Section 88(1) of the ITA.

The said provison is only regarding the payment of interest, the withholding rate provided by Section 88(1) of the ITA will be applicable (i.e., 15%) while making payment of other fees under the loan agreement.

4.3 Tax exemption in Nepal

4.3.1 *Exemption under DTAA*

If Nepal has entered into the Double Taxation Avoidance Agreement ("**DTAA**") with another country, and the income is taxable in both countries, the beneficial tax provisions (exemption or lower rate of tax) under the DTAA would be applicable. Nepal has entered DTAA with eleven countries, namely, (i) India, (ii) Mauritius, (iii) Republic of Korea, (iv) China, (v) Norway, (vi) Qatar, (vii) Sri Lanka, (viii) Thailand, (ix) Austria, (x) Pakistan and (xi) Bangladesh.

4.3.2 *Exemption under agreement with Government of Nepal*

The Government of Nepal (GoN) can provide tax exemption to any institution by entering into an agreement. Any income obtained from the investment from a party by entering into the bilateral or multilateral agreement with GON (referred as '**Agreement**') is treated as exemptible amount under Section 10 of the ITA and accordingly the income is provided with tax exemption facility as provided by the Agreement. The Agreement entered by the parties under these provisions are considered as having a commercial nature and does not require the ratification or promulgation from the federal parliament of Nepal. Thus, negotiating and entering into bilateral agreement with GON will be sufficient to provide a tax exemption on the investment made in Nepal.

As mentioned above, the ITA provides tax exemption based on agreements entered between GON and foreign countries or international institution. Following institutions have obtained tax exemptions under the provision:

	Name of DFIs	Agreement Name
1	IFC	- Article of Agreement signed and deposited by Nepal in the World Bank Group's Corporate Secretariat. - IFC Membership Acquisition Act 2022 (1965)
3	ADB	- Agreement Establishing the Asian Development Bank

The said agreements provide tax exemption to the ADB and IFC on their assets, property, income and their operation and transactions, including any obligation for the payment, withholding or collection of any tax or duty.

4.3.3 Exemption under Finance Act, 2022

The GON can also provide tax exemption under Section 18 of the Finance Act. The list of exemption under the Finance Act is updated at the start of every fiscal year and replaces the provisions of previous Finance Act. Therefore, this tax exemption obtained from the Finance Act are only provided temporarily (i.e., one fiscal year).

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