Newsletter Vol. I

June 2025

This newsletter is born out of our commitment to innovation and client-focused service. As a firm rooted in the knowledge industry, we believe that creativity and originality are essential to everything we do. Our updates reflect not just the law as it is, but how it affects the people and businesses we serve. It is our way of honouring the trust placed in us and keeping you informed, empowered, and ahead.

This newsletter will be published at the end of every four months, following the English calendar

Inside This Edition

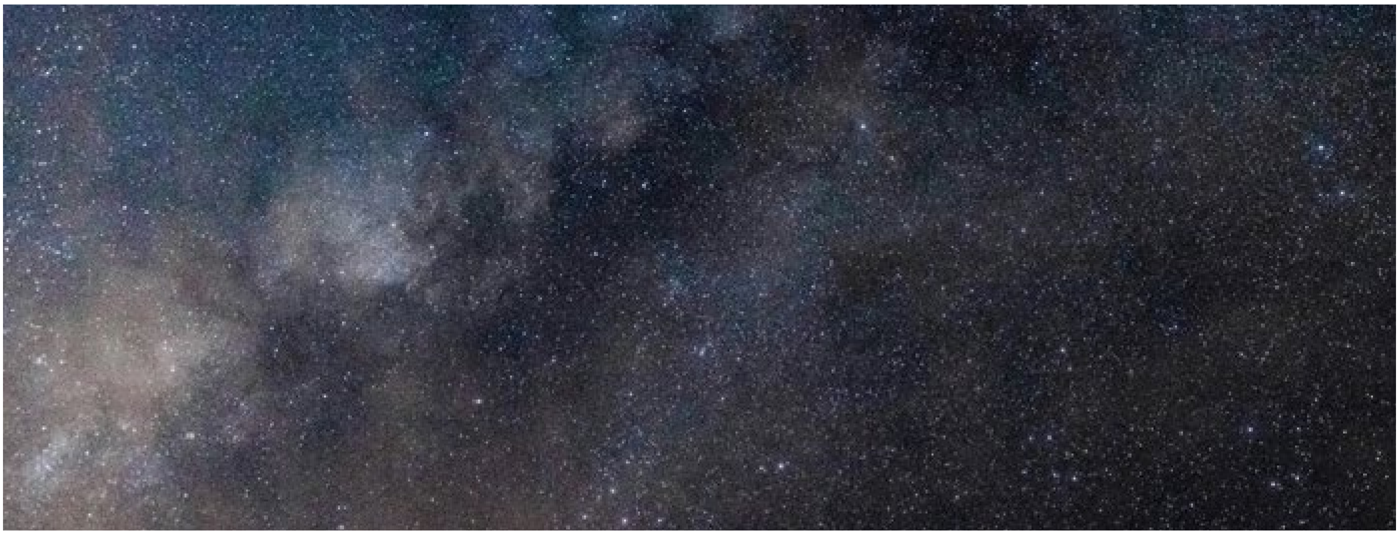
INFINITY PARTNERS

A Full Service Law Firm

Infinity Partners

A full-service law firm : Your trusted legal partner

Infinity Partners is a full-service law firm that provides comprehensive legal solutions tailored to meet the unique needs of our clients. With a deep understanding of Nepal's local landscape and global best practices, we specialize in commercial law, civil law, dispute resolution and legal reform.

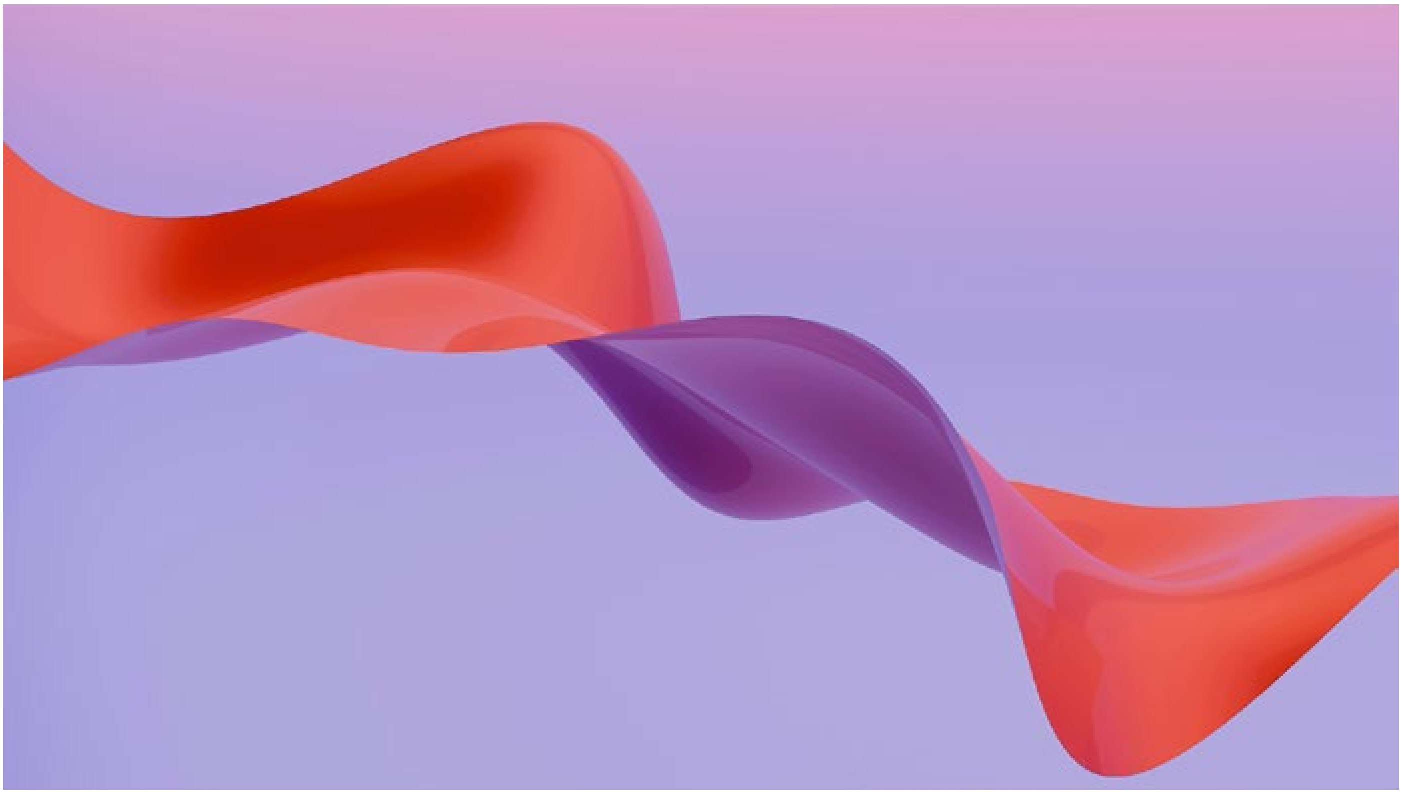


Our Values

We are guided by core values: Integrity, Inclusion, Innovation, Sustainability and Client-Centricity.

Client-Centricity

Equally, we place our clients at the centre of every decision we make. Their goals shape our approach, their trust drives our integrity, and their success is how we measure our own.



Featured Update

Finance Bill, 2082: Key Changes in Taxes

Background

On May 29, 2025, the Finance Minister, Mr. Bishnu Prasad Paudel had presented the budget of Federal Government of Nepal for Fiscal Year 2025/26 (2082/83) along with the Finance Bill, 2025 (2082) **(the "Finance Bill")**, Appropriation Bill 2025 (2082) and National Debt Bill 2025 (2082).

Among the other Bills, the Finance Bill introduces new tax headings, tax amnesty schemes, and amendments to major tax laws of Nepal including Income Tax Act 2002 (2058), Value Added Tax Act 2052 (1996), Excise Duty Act, 2058 (2002) and Customs Act 2064 (2007).

The Finance Bill is fully effective after it is passed from both the houses of Federal Parliament, is certified by the President and published in the Nepal Gazette notification. However, some of the provisions listed in the Schedule is effective immediately (i.e., from May 29, 2025).

This update will highlight the key amendments and provisions introduced by the Finance Bill 2025, focusing on major tax incentives, procedural clarifications, and continuity in tax amnesty schemes from previous fiscal years.

Major Highlights

1) **Expanded income tax exemptions for IT, Hotel, and Tourism sectors under Income Tax Act, 2002 (the "ITA")**
The Finance Bill and the Budget Speech has put special attention to promote participation of private sectors in IT, and hotel and tourism. There are several income tax exemptions and facilities provided to IT sector, and hotel and resort sector which were previously exclusive to the Special Industry only (i.e., Manufacturing industries, agriculture and agro-forestry industries and mineral industries). One of the major facilities in the Finance Bill is that it provides tax concession of 20% in the applicable corporate tax rate as per the ITA to Information Technology (IT), hotel and resort business.

2) **Expansion of Income Tax Exemption for Start-Up Entities**
The Finance Bill has amended the previous facility for start-up business, making the startup entity with annual turnover up to NPR. 10 crores eligible to obtain full exemption of income tax for initial five years of operation.

3) **Digital Services No Longer Subject to Permanent Establishment Regulation**
The Finance Bill has removed the requirement for a permanent establishment for non-resident (foreign) entities providing digital services in Nepal under the ITA. As a result, such digital service providers are now required to comply with only Digital Service Tax (DST) and VAT regime in Nepal and are not required to pay profit tax under the ITA.

After the amendment, the digital service providers offering services to customers in Nepal and generating annual turnover exceeding NPR 3 million must pay a 2% DST on their annual turnover. Additionally, the Finance Act has also exempted business to business (B2B) digital services applicable to DST.

Similarly, there has been no change in requirement of registration for the VAT. The amendment to the VAT Act 1996 (2052) (the "VAT Act") has clarified some previous activities and included additional activities within the definition of digital services in the VAT Act. As such the non-resident digital service providers are required to issue VAT invoice for the fees that they charge to customers.

4) **Exemption of Charges and Interests applicable in Change in Control**
The Finance Bill has provisioned to waive applicable charges and interest on income tax arising from corresponding change in control in the interest held by the resident entity in another resident entity. For the purpose, such entity which is required to pay income tax from Change in Control between resident entity in Nepal shall be waived from all applicable interest and charges if it pays applicable income tax made by revised tax assessment within end of the fiscal year 2025 (i.e. July 15, 2025).

5) **Continuity with Major Tax Amnesty Scheme and Tax Heading from the Previous Finance Act**
The Finance Bill 2025 retains several key tax amnesty schemes and tax headings from the previous Finance Act. Notably, it continues to offer waivers on applicable interest, fees, and penalties for VAT and excise tax—provided the taxpayer settles the principal tax amount. However, the rates and eligibility criteria for these amnesty benefits under the Income Tax Act have been revised.
On the other hand, the tax amnesty scheme that previously allowed taxpayers to waive accumulated interest and penalties for failing to register under PAN—conditional upon registering for PAN

and filing income tax returns for F.Y. 2021/22 and F.Y. 2022/23—has been discontinued. Further, the Finance Bill does not specifically provide any tax amnesty in cases where there is dispute under consideration of the IRD, Revenue Tribunal or Supreme Court.

6) **Legal Remedies Clarified for Specific Tax Assessments in the Finance Act**
The Finance Bill has introduced much-needed clarity regarding the legal remedies available to challenge tax assessments made under certain tax headings. Assessments made under 'Luxury Tax' and 'Health Risk Tax' can now be contested through an administrative review at the Inland Revenue Department. Furthermore, decisions from this review may be appealed before the Revenue Tribunal. However, the Finance Bill still lacks general legal recourse to challenge tax assessment under other headings besides the abovementioned. For instance, the Finance Bill still has not provided any recourse against the assessment made under DST and other tax headings.

New Tax Allocation in Various Sectors under the Finance Act, 2025

1) Information Technology Sector

The Information Technology Sector has been considered with key interest in the Budget Speech 2025/26 as well as the Finance Bill. The Budget prioritizes on expanding the infrastructure and technology and scope of IT services in Nepal. For the purpose, the Finance Bill has provided various incentives and tax exemptions that encourages entities to participate in business activities of IT Sector. Following are the exemption and facilities provided from the Finance Bill in the Income Tax Act 2002 (2002) (the "ITA"):

Effective Tax Rate for IT Sector

The Finance Bill has provided IT sector eligible for incentives in tax rates. Previously, this facility was only provided to the Special Industry. 20% of tax is reduced from applicable income tax to entity working in IT Sector of Nepal. This makes the effective tax rate of entity in IT Sector to be 20% which was previously 25%.

A. Exemption Facility for Specific IT Industry

Industries related to software development, data processing, cybercafe, digital mapping establishing in technological park specified by the Government of Nepal by a Nepal Gazette notification shall have 75% exemption from income tax. Previously, the exemption rate was 50%. As the Government of Nepal has not published Gazette notification to designate the technological park yet, the provision remains practically ineffective.

B. Expansion of Income Tax Exemption Facilities for Start-Up Industries

The Finance Bill has expanded the scope of start-up businesses by allowing those with an annual turnover up to NPR 10 crores to claim an income tax exemption for the first five (5) years of operation. Previously, the facility was limited to startup business with annual turnover of NPR 1 crore. However, as per the ITA, the facilities can only be utilized by start-up industries as defined by the notification of Inland Revenue Department ("IRD").

C. Income Tax on Export of IT Services: The Finance Bill has mentioned that the final withholding tax of 5% shall be levied on the income of person, exporting information technology services abroad.

D. Digital Service Provider: The Finance Bill has removed the applicability of permanent establishment for foreign entity providing digital services in Nepal. Previously, a foreign entity was considered under permanent establishment 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").

After the amendment, the Digital service providers offering services to customers in Nepal and generating annual turnover exceeding NPR 3 million must pay a 2% DST on their annual turnover.

However, the Finance Bill has not provided any legal recourse to challenge the reassessment made by the tax officials under the DST. For instance, if the tax officials reassess the liability under DST after the person has declared and submitted the DST then the person no legal recourse to challenge the reassessment under the Finance Bill.

In relation to amendments to the VAT Act, there has been no significant changes in the applicable conditions of VAT on digital services although there have been few additional business activities included in the digital service.

2) Transportation Sector

A. Exemption of Tax for Old Public and Private Vehicle

The Finance Bill has introduced a provision to grant the remaining income tax exemption to public and private vehicles older than 20 years or those who do not come into operation, for the purpose of deducting their income tax of last two years.

B. International Civil Aviation Provider and Ticket Seller

The Finance Bill has waived applicable interest, charges, and additional fees until fiscal year 2025 for entities that register for VAT and pay the applicable VAT on services from fiscal year 2023 by the end of fiscal year 2025.

C. Continuation of Tax from Previous Fiscal Year

The Finance Bill has carried over with certain tax headings from previous fiscal years. As per Bill, concerned person is required to pay green tax, road construction fee, road maintenance and improvement fee, pollution control charges.

D. Claim of Rental Expense Paid to a Natural Person: The Goods Transport Service Provider who have rented vehicles from natural persons may claim the rental expenses for fiscal years 2023/24, 2022/23, and 2021/22, provided that Tax Deducted at Source (TDS) was duly withheld on such payments.

3) Renewable Energy Sector

A. Electric Charging Machines: An entity manufacturing and assembling charging machines for electric vehicles shall obtain full income tax exemption for the initial 5 years from the date of operation.

B. Production of Green Hydrogen: Similarly, an entity producing green hydrogen shall obtain full income tax exemption for the initial 5 years from the date of operation.

4) Hotel & Resort Sector

A. Effective Tax Rate for IT Sector: Similar to IT Sector, the Finance Bill has provided hotel and resort sector with incentives in the applicable tax rates under ITA. As per the facility, one third of tax is reduced if the natural person falls within the tax bracket of 30%. This makes the effective tax rate for the person to be 20%. Similarly, 20% of tax is reduced from applicable income tax to entities. This makes the effective tax rate of entity in IT Sector to be 20% which was previously 25%.

B. Waiver of Income Tax Based on Number of Employment and Location of the Industry: The hotel and resort has been included with IT sector and special industry to obtain waiver of income tax based on its rate of employment of people and location of the industry. The following provides the list of tax waiver facility:

Based on Number of Employees

Entities (throughout the year)	Incentives (in such income year)
100 or more Nepalese nationals	The tax is applicable only 90% of the applicable rate
300 or more Nepalese nationals	The tax is applicable only 80% of the applicable rate
500 or more Nepalese nationals	The tax is applicable only 75% of the applicable rate
1000 or more Nepalese nationals	The tax is applicable only 70% of the applicable rate
100 or more Nepalese nationals including 33% women, Dalits or handicapped	Additional 10% exemption

C. Requirement for Five Star & above, and luxury hotels to file Luxury Taxes
The Finance Bill has increased the applicability of luxury tax for hotels of five star & above and luxury resort. Upon the inclusion of luxury tax, two percent tax is levied on the sales price of services provided by luxury resort, hotel of five star and above. The luxury tax is levied directly on the revenue stream of the business.

Special provision for Waiver of Dues & Relief

The major tax amnesty schemes which have continued this fiscal year includes waiver of certain applicable interest, fees and charges under income tax, VAT and excise tax if the taxpayer complies with certain provisions. However, there has been certain change in the eligible conditions and relief under the current Finance Bill.

Here is the updated list of the special provision related to Dues and Relief:

A. Waiver of applicable charges and interest under Change in Control from onshore transfer of shares
A resident entity which is required to pay income tax from Change in Control from onshore transfer of shares between resident entity in Nepal has been waived from all applicable inter-

est and charges if it pays applicable income tax made by revised tax assessment within end of the fiscal year 2025. (i.e., July 15, 2025). This provision does not facilitate Change in Control occurring from offshore transaction.

B. Failure to submit income tax returns

A person who receives a revised tax assessment from the tax office for failing to file an income tax return will be exempt from the additional tax liability under that revised assessment—provided they file the overdue return and pay the due income tax for that fiscal year by January 2026. However, this waiver is not applicable to income tax reassessment in the tax headings of income tax returns filed by the person.

C. Failure to submit VAT until the F.Y. 2024/25 A person who failed to register under VAT and VAT returns for the period until the fiscal year 2024/25 shall obtain wavier of all fines, fees and remaining interest if the person submits VAT returns and pay twenty five percent of the applicable interest thereon, within January 2026. The person had to submit VAT returns and pay fifty of applicable interest to receive the waiver under the tax amnesty scheme as per the previous Finance Act 2024.

D. Failure to submit Excise Duty until the F.Y. 2024/25: A excise license holder who failed to determine and collect excise duty until the F.Y. 2024/25 shall obtain waiver of all fines and delay charges if the excise license holder submits the excise duty return and fifty percent of applicable delayed charges within January 2026.

Similarly, a person who has already filed the excise duty return for the fiscal year but fails to provide the excise duty shall also obtain waiver of all fines and delay charges if it submits the applicable excise duty within January 2026.

Major Tax Amnesty Schemes and Tax Heading Revoked from the previous Finance Act

While major tax heading and tax amnesty schemes are retained from the previous Finance Bill, there are some provisions which have been revoked and discontinued:

1) **Tax Amnesty Scheme for Person doing taxable transaction without obtaining PAN**
The tax amnesty scheme provided to person doing taxable transaction without obtaining PAN has been removed in the Finance Bill. In the previous Finance Act 2024, a person who is conducting taxable transactions without obtaining the PAN were eligible to obtain waiver of all applicable tax before F.Y. 2021/22 if the person registered under PAN, filed income tax returns for F.Y. 2021/22 and F.Y. 2022/23 and paid the taxes thereon within March end of 2026.

2) **Approved Social Security Fund**
The concept of approved social security fund approved by the Inland Revenue Department has been removed from Finance Act and Income Tax Act. As per the Finance Bill, the retirement funds approved from the Inland Revenue Department must obtain affiliation with retirement funds established under the existing Nepalese laws which includes Employer Provident Fund, Citizens Invest-

ment Trust, Pension Fund or Social Security Fund.

3) **Advance Tax Deduction at Customs Points**
The Finance Act 2023 had introduced a provision for advance tax deductions at customs points on various imported goods, including live animals, meat, dairy products, and other essential goods. This provision has been removed from the Finance Bill.

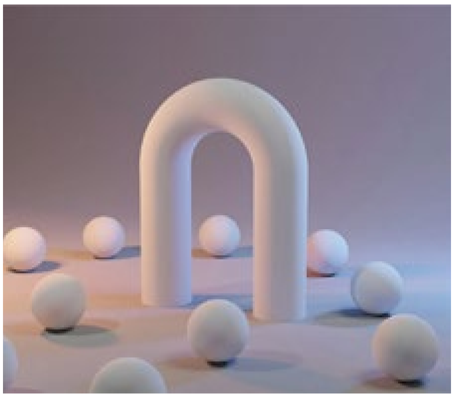
4) **Permanent Establishment on Digital Service Provider**
The Finance Bill has removed the applicability of permanent establishment for foreign entity providing digital services in Nepal and has limited the applicability of DST in business to consumer activities (B2C) and not in business-to-business activities (B2B).

Legal Changes

This section covers recent changes in laws and policies that impact businesses, investments, and governance in Nepal.

Amendment in the Land Act

The Government of Nepal introduced the Ordinance to Amend Certain Nepal Acts Related to Land, 2081, on 2081.10.02, aiming to revise provisions on land ceilings, land use, and categorization. For more information, Read here. However, as the ordinance was neither tabled before Parliament nor approved within the stipulated timeframe, all proposed amendments now stand void. For more information, Read here.



Amendments to the Privatization Act

Nepal amended its Privatization Act through Ordinances to enable more strategic and flexible management of state-owned assets. These changes aim to attract investment and enhance transparency through new oversight mechanisms. If your business is engaged with or planning to invest in a public enterprise, understanding these reforms is essential. For more information, Click here

Amendment in the Foreign Investment

Nepal has introduced key amendments to its foreign investment laws through an ordinance aimed at enhancing regulatory clarity and strengthening investor confidence. Notable changes include permitting outward investments by Nepali entities, broadening the scope of technology transfer to cover IT and digital services, and allowing Project Development Agreements to be used as collateral for loans. If your business is involved in or plans to attract foreign investment, aligning with these reforms is essential. For more information, Click here.

Changes in the Business Climate Regime

Nepal introduced an ordinance bringing important changes to various laws governing business operations. Notable changes include the simplification of environmental assessment procedures, introduction of facilitation measures and concessions, fast-track services for arbitration, and defined timelines for administrative decisions. If your business is planning to operate, invest, or expand in Nepal, understanding these updates are essential. For more information, Click here

Amendment in Prosecution Laws

Nepal introduced key amendments to its tax offence and prosecution laws through an ordinance. Businesses now have the option to settle certain cases administratively without facing criminal prosecution, provided the offence was not intentional and qualifies under prescribed thresholds. For more information, Click here.

Investment Facilitation Act Amendments.

Nepal introduced the Investment Facilitation Act, 2081 (2024) to simplify investment procedures and remove legal hurdles by amending 17 existing laws. Startups are now formally recognized under the Industrial Enterprise Act, and local and provincial governments are required to establish Investment Promotion Centres to assist and coordinate with businesses. If your business is planning to invest in Nepal, understanding these changes is important. For more information, Click here.

Amendment in the Food Laws

To improve public health and consumer safety, Nepal enacted the Food Hygiene and Quality Assurance Act, 2081 (2024), introducing stricter standards for food quality, hygiene, and compliance. If your business is involved in food production, packaging, distribution, or imports, aligning with the revised legal and procedural requirements under this law is essential. For more information, Click here.

Guide to Foreign Loan Regulations

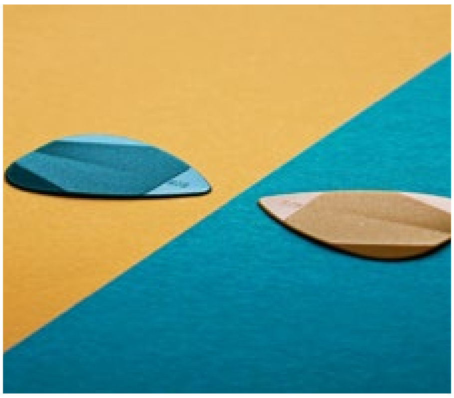
Foreign loans are an important option for businesses needing substantial capital for expansion. To ensure transparency and economic stability, Nepal Rastra Bank has set out clear procedures for borrowing from foreign lenders. If your business plans to raise funds from abroad, you must confirm your eligibility, choose from approved lenders, and follow NRB's procedural requirements. For more information, Click here

Case Law Highlights

This section highlights important decisions delivered by the Supreme Court of Nepal, shedding light on tax law, corporate liability, sustainability, and regulatory compliance.

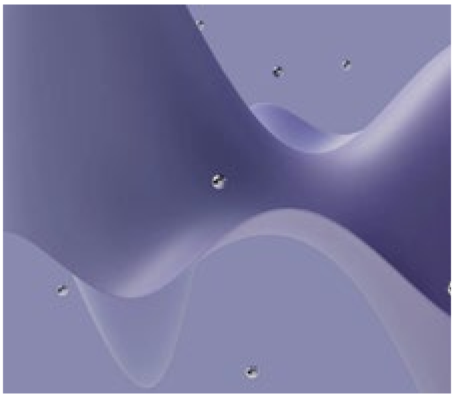
Bhatbhateni Supermarket v. Inland Revenue Department

This Supreme Court decision arose from a long-running dispute involving Bhatbhateni Supermarket and the Inland Revenue Department over the alleged use of fake VAT invoices to claim input tax credit. The Court confirmed that such practices constitute a serious tax offence and emphasized the need for genuine, verifiable transactions in VAT reporting. If your business handles high-volume transactions or VAT-related documentation, maintaining transparency and accuracy is critical to avoid penalties. For more information, Click here.



Large Taxpayers Office vs. United Spirits Nepal

This case involved a dispute between United Spirits Nepal Pvt. Ltd. and the Large Taxpayers Office regarding the deductibility of certain expenses without prior formal approval. The Supreme Court clarified that while tax deductions may be allowed, they must strictly follow the procedures set by law, and informal practices will not suffice. For more, Click here.



Advocate Bigyan vs. Government of Nepal

This Supreme Court case arose from a petition against an amendment to the Working Policy on Infrastructure in Protected Areas. The amendment allowed larger hydropower projects and reduced minimum water discharge requirements for those over 100MW, which petitioners argued would harm biodiversity. The Court emphasized that development must align with environmental protection, reinforcing the principle of sustainable development.
For more information, Click here.

Ramila Devi vs. Nepal Government

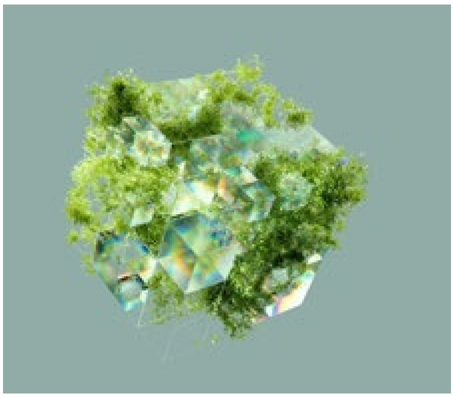
This case originated from allegations by depositors of Manas Sahakari that their funds were misappropriated when the cooperative failed to return deposits. The Supreme Court examined whether mere board membership equated to liability and adopted the "controlling mind" doctrine, holding that only individuals with direct intent and control over the fraudulent acts could be held responsible. If you serve on the board of a cooperative or financial institution, it is essential to maintain clear records of your decision-making role and oversight activities to mitigate personal liability. For more information, Click here.

Swawalamban Microfinance Financial Institution Limited vs. Labour Court and Others

In this landmark decision, the Supreme Court of Nepal held that the Labour Court does not have first-instance appellate jurisdiction over labour disputes involving banks and financial institutions regulated by the Nepal Rastra Bank, provided such institutions are regulated by NRB-approved bye-laws. The Court emphasized that disputes must first be addressed through the internal mechanisms set out in these bye-laws, reinforcing the autonomy of financial institutions in handling internal employment matters. Read more here

Legal Guides

Designed to help businesses, and professionals navigate Nepal's legal landscape, these guides provide compliance requirements and clear procedural information.

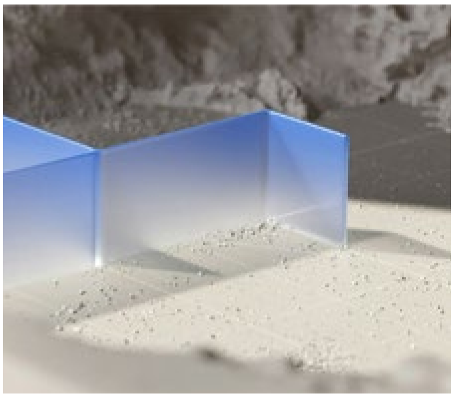


CSR in Nepal

Corporate Social Responsibility is now a legal obligation for certain businesses in Nepal. If your business meets the CSR threshold, you are required to undertake activities, such as promoting education, healthcare, environmental protection, or community development and fulfil detailed reporting and procedural requirements. For more information, Click here.

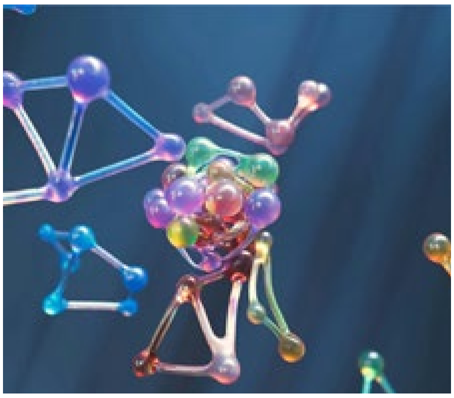
Employment Termination Procedures

Termination of employees is a sensitive matter in Nepal, where the law strongly upholds job security and fair treatment. If your business intends to terminate staff on grounds such as misconduct, underperformance, or redundancy, specific legal procedures must be followed, including clear justification and proper notice. Failure to comply with these obligations may result in significant legal and financial consequences. For more information, Read here



Work Permit Guidelines for Foreigners in Nepal

In today's increasingly global business environment, Nepalese enterprises may require foreign expertise to support operations, introduce technical know-how, or fulfill senior management roles. However, the recruitment of foreign nationals in Nepal is subject to specific legal procedures and regulatory conditions. If your business intends to hire foreign professionals, it must first assess whether the proposed role qualifies under Nepalese law and then identify the appropriate route for recruitment. For more information, Click here



INGO Welfare Project Guidelines

International Non-Governmental Organizations contribute meaningfully to Nepal's social development through various welfare initiatives. If an INGO is planning to initiate or support welfare projects in Nepal, it must do so in accordance with the national regulatory framework. This involves entering into agreements with the Social Welfare Council, collaborating with local NGOs where required, and ensuring full compliance with applicable tax and reporting obligations as part of its operational responsibilities. For more details, Refer here

Essential Guide to Bonus Laws

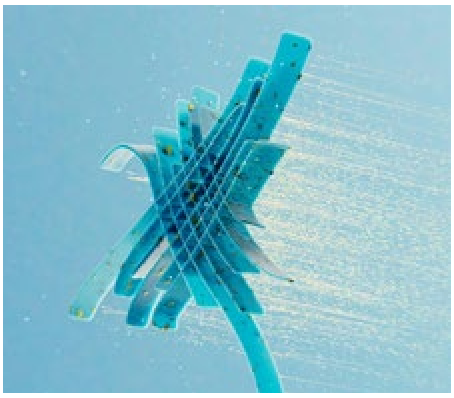
In Nepal, the bonus regime is a legally mandated system that ensures employees of profit-making enterprises, such as financial institutions, receive a share of the profits based on their remuneration. If your business employs staff and falls within the scope of such enterprises, bonus distribution becomes a statutory obligation. The calculation of bonuses is typically based on the employee's basic salary and regular allowances. For more information, Click here

Differences Between Regular and Contractual Employees

Proper classification of employees plays a vital role in determining their working hours, entitlements, and termination procedures. If your business employs different types of employees, it is important to distinguish between permanent and contractual roles, as each category comes with specific legal implications and obligations. For more information, Click here

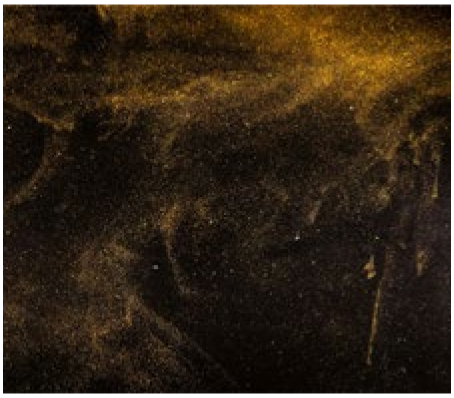
A General Guide to IPO

Embarking on an Initial Public Offering is a significant milestone for public limited companies in Nepal seeking to raise capital and enhance market credibility. Governed by the Securities Exchange Board of Nepal , the IPO process requires companies to meet strict eligibility criteria, obtain credit ratings, and comply with detailed disclosure and reporting requirements. If your company is considering listing, early preparation using this guide can smoothen the process. For more information, Click here



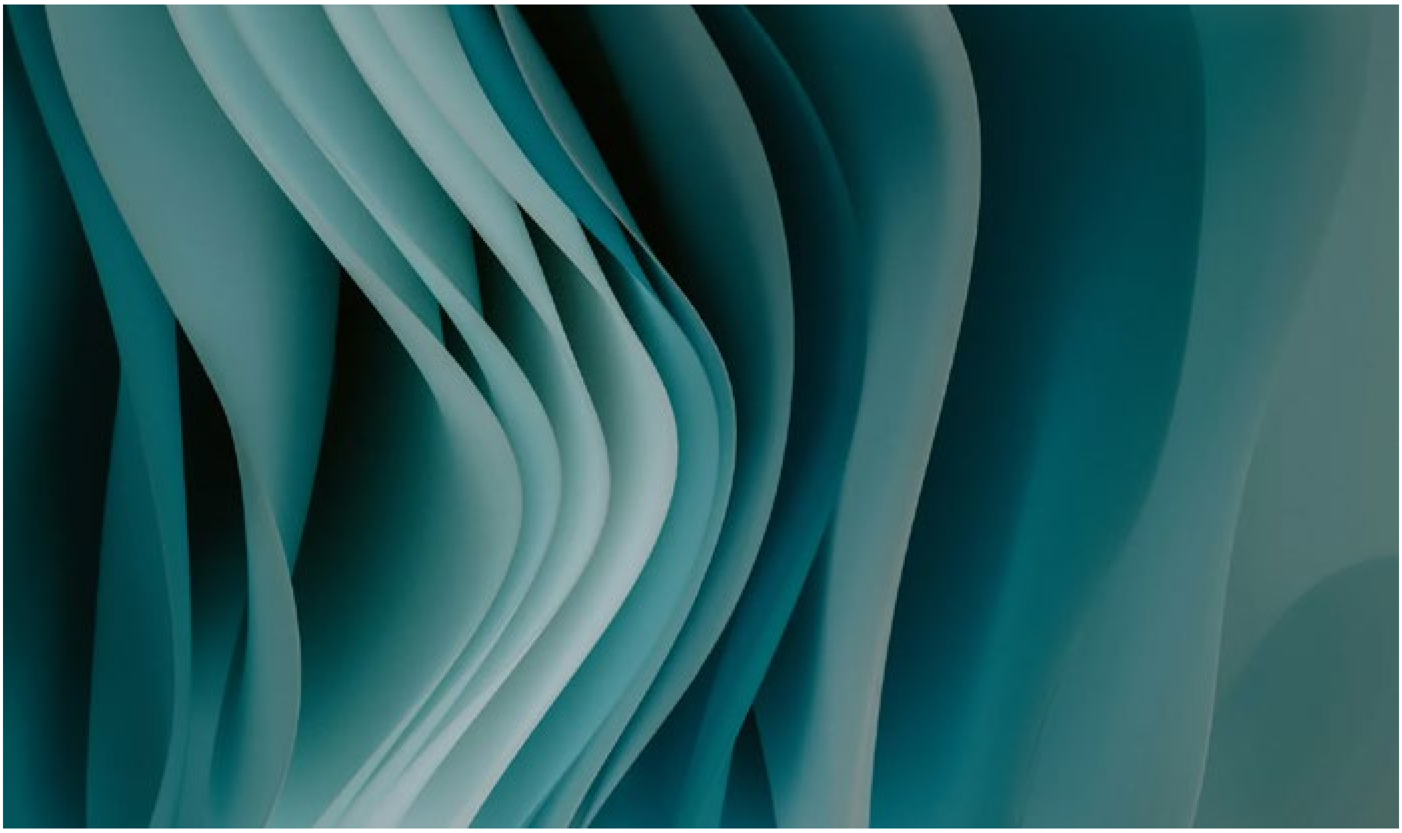
Redundancy and Compliance

Redundancy in Nepal must be managed with careful legal and procedural compliance to safeguard both employer and employee interests. If your business is considering workforce reduction due to restructuring, downsizing, or closure, it is essential to follow lawful processes, such as providing notice, seeking necessary approvals, and ensuring fair compensation. For more information, Click here.



Effect of Foreign Divorce Decree on Property Claims in Nepal

With the growing number of Nepali citizens residing abroad, foreign divorce proceedings have become increasingly common. This development raises critical legal questions regarding the rights of spouses, particularly wives, to claim partition of property in Nepal when a divorce petition is either pending or has been finalized in a foreign jurisdiction. This article examines the applicable legal framework under the prevailing laws of Nepal along with relevant Supreme Court precedents, and other related statutory provisions to clarify the legal standing and procedural considerations involved in such cases. For more information, Refer here.



Featured Article

Thin Capitalization: A Nepalese Perspective

Concept

The capital structure of a company can be financed through either equity or debt or combination of both. When a company's debt financing substantially exceeds its equity financing, it is referred to as thin capitalization, meaning the company is thinly capitalized.

To prevent such situations of excessive debt financing, thin capitalization rules have been introduced. Thin capitalization rules are designed to limit the extent to which a company can finance its operations through debt as opposed to equity. These rules typically restrict the amount of interest expense that can be deducted for tax purposes when a company's debt-to-equity ratio exceeds a specified threshold. The objective of thin capitalization rules is to prevent companies from disproportionately relying on debt to reduce their taxable income through excessive interest deductions, thereby ensuring a fair and balanced approach to corporate financing and taxation.

Thin Cap Rule- A Necessity

Companies often prefer debt financing over equity financing due to several key reasons related to tax benefits. Here are the main reasons:

Claim of Interest Expenses

When a company is financed through equity, the returns on equity, in the form of dividends, are subject to dividend tax. Additionally, the company's profits are subject to annual corporate tax. These tax obliga tions arise only when the company generates profits, implying that, for equity investors to receive returns, the company must first record net profit. Consequently, the company faces dual tax liabilities: corporate tax on its profits and dividend tax on the distributed dividends. This dual taxation can significantly impact the overall returns from equity financing.

For example, in Nepal, the general corporate tax rate is 25%, as stated in Subsection 2 of Schedule 1 of the Income Tax Act, 2058 (2002). Additionally, when dividends are distributed from profits, a 5% dividend tax is withheld in accordance with Section 88(2)(a) of the Act. This means that a company financed through equity may face an effective tax rate of approximately 30% on its profits.

When a company is financed through debt, the interest expenses on these debts are deductible from the company's taxable income. This reduces the company's tax liability, regardless of whether the company is profitable or not. For example, if a subsidiary company is entirely or excessively financed through debt, the interest expenses can significantly reduce its taxable income. This is because interest payments are considered business expenses and are deductible from income before taxes are calculated.

Unlike dividends, which may only be distributed from net profits or reserves, interest is paid directly from revenue, thus providing a significant tax advantage to debt financing. For example, in the context of Nepal, Section 88 of the Income Tax Act stipulates that a withholding tax of 15% must be applied when aresident person makes a payment for interest sourced from Nepal. As per Section 92 of the Act, this 15% withholding tax is deemed final, and no further tax liability will be imposed on the interest payment. This renders the withholding tax on interest more economical compared to the tax levied on net profit and dividends, thereby offering a compelling incentive for companies to favor debt financing over equity financing.

In this way, debt financing offers more favorable tax treatment, as it provides consistent tax benefits irrespective of the company's profitability. Interest expenses are deductible from taxable income, thereby reducing the company's tax liability, even in years when it does not generate a profit.

Profit shifting/Debt Shifting

Companies often engage in debt shifting by borrowing money from their own parent companies in low-tax countries to finance operations in high-tax countries. This allows them to deduct the interest payments from their taxable income, reducing their tax liability. This practice is known as "debt shifting" and helps companies save on taxes.

In conclusion, thin capitalization rules are designed to mitigate these tax avoidance strategies by limiting the deductibility of interest expenses. These rules encourage companies to use more balanced finaning methods, ensuring they pay their fair share of taxes and reducing the incentive for profit shifting.

How are the Thin Capitalization Regulated?

Number of jurisdictions have applied different regulations to curb and regulate the thin capitalization. The following are the principal methods used by some jurisdictions to curb the thin capitalization:

a) Fixed Ratio Method

These rules set limits on the level of interest expenses or debt for a company or entity, based on fixe ratios related to debt-to-equity, interest, or earnings.

b) Earning Stripping Rule (Specified Percentage)

These rules prohibit a specified percentage of interest expenses for a company or entity, regardless of the nature of the payment or the recipient.

c) Arm's Length Basis

These rules compare a company's or entity's level of interest or debt with what it would be if the com pany was dealing exclusively with third parties.

d) Anti-Avoidance Rules

These are specific anti-avoidance rules that prohibit interest on certain transactions.

Practices in Different Jurisdiction

The table below depicts the measures adopted by some of the major economies:

S.N.	Country	Legal Instrument	Measures
1.	India	Income Tax Act, 1961 (Section 94B) Introduced in 2017	• Application of 'Specified Percentage methode' or 'Earning Stripping Rule.' • 30% of earning before EBITDA of previous year or amount of interest paid to associated enterprise previ- ous year, whichever is less. • The excess of above-mentioned condition is regarded as excess interest and disallowed for deduction.
2.	USA	Internal Revenue Code, 1986 (Section 163(j)(2)(A)(ii)) Effective since 1989	Application of 'Fixed Ratio Rule' or 'Safe Harbour rule' • Debt to equity ratio is 1.5: 1. • The interest allocated exceeding above ratio will be disallowed.
3.	Canada	Income Tax Act, 1985 (Section 18(4) to (8).)	Application of 'Fixed Ratio Rule' • Debt equity ratio is 1.5 :1. • The interest allocated exceeding above ratio will be disallowed.

How thin capitalization is regulated in Nepal?

There is currently no specific provision for a thin capitalization under the Income Tax Act. Instead, the application of general anti-avoidance rules is subjectively employed in practice to address interest deductions and thin capitalization issues. However, concerning foreign investment, an insight can be drawn from the byelaw adopted by Nepal Rastra Bank(the "NRB"), which regulates the debt-to-equity ratio of investing foreign companies.

To better understand the framework surrounding thin capitalization in Nepal, it is essential to analyze the available provisions of following instruments.

Income Tax Act, 2002

The Income Tax Act lacks explicit provisions on thin capitalization. However, § 14(2) of the Act addresses the deduction of interest expenses which outlines the conditions under which interest can be deducted for an income year. These provisions are applicable only when:

a) There is a resident entity controlled by an organization entitled to tax exemption, and

b) The interest is paid to the controlling or concerned person. However, any disallowed interest may be carried forward or credited in the subsequent income year.

The Act also contains general anti-avoidance rules aimed at preventing tax evasion. § 33 deals with Transfer Pricing between related parties, § 34 addresses Income Splitting, and § 35 focuses on Tax Avoidance Schemes. These provisions are designed to regulate financial transactions and ensure tax compliance but do not specifically address thin capitalization. Under these rules, when related parties engage in transactions at arm's length, the Inland Revenue Department or Inland Revenue Office may issue a notice to appropriately allocate or apportion the amounts for tax purposes, ensuring that taxable income or payable tax reflects standard market conditions.

In view of above, § 14 pertains exclusively to resident entities controlled by tax-exempt organizations, as defined in § 2(s), and only covers interest payments made to the controlling entity. It does not define any debt-to-equity ratio or set limits on the percentage of interest deductible for tax purposes. In the absence of specific provisions, tax authorities often rely on general anti-avoidance rules outlined in § 33, 34, and 35 to regulate interest deductions, leading to subjective interpretations and applications of the law. This underscores the need for specific legal provisions in Nepal to effectively address thin capitalization and ensure clarity in tax and financial regulations.

Permanent Establishment (PE) Directives, 2020 (2077)

It is issued under the Income Tax Act, the PE Directives, further clarify interest deduction rules for permanent establishments (PEs). According to Section 11.8, interest deductions are not allowable for related-party loans. However, if a parent company borrows from another entity and a portion of the loan is utilized by the PE, the interest on such loans can be deducted. Provision of the PE Directive seems to be substantive in nature going beyond the boundaries of the Income Tax Act and rules of delegated legislation.

Foreign Investment & Foreign Loan Management Byelaw, 2021 (2078)

In an effort to regulate foreign investment and loans, Nepal Rastra Bank, the Central Bank of Nepal introduced the Foreign Investment and Foreign Loan Management By-Law, 2078(2021) (the "Byelaws"). Schedule-10 of the Byelaws outlines provisions related to foreign loans, specifying the borrowing limits that companies and industries with foreign investment must follow when obtaining loans from their parent company or other group of companies. An amendment passed by the Board of Directors of Nepal Rastra Bank on 2080/10/10 (corresponding to January 24, 2024) permits these entities to borrow up to twice (2x) the paid-up capital of the respective foreign investor. This provision is only applicable to those investors which already has equity investment and wants to provide loan.

In conclusion, while the Byelaws issued by NRB regulates the required equity-to-debt ratio in foreign investments, it does not address tax implications and is not intended for tax regulation. Furthermore, this provision applies only to shareholders who already have injected equity investments in the company.

A Path Forward for Nepal

The specific but a balance regulation is necessary to prevent companies from artificially inflating their debt-to-equity ratio to minimize taxable profits while giving space for the companies to meet their financing needs.

The Earning Stripping Method or the Specific Percentage Method (similar to those adopted in India) could serve as viable option for Nepal. Rather than imposing strict controls on debt levels, the regulations can focus on limiting interest deductions. However, it is crucial that any limitations on interest deductions are not overly stringent, they must promote and investment friendly environment that balances the interest of both investors and the country's tax objectives.

As an economically emerging country, Nepal should adopt a balanced approach that encourages foreign investment without hampering business growth. Implementing thin capitalization rules akin to those in India could be beneficial. For instance, allowing companies to deduct 30% of their interest expenses based on EBITDA (Earnings before Interest, Tax, Depreciation and Amortization) in a fiscal year. Furthermore, any excess interest that cannot be deducted in the current year should be allowed to carry forward for up to 8 years. This kind of approach aligns with international best practices while ensuring that Nepal remains an attractive destination for foreign investment. By carefully regulating how much interest can be deducted each fiscal year and providing the option to carry forward unused deductions, we can create a tax environment that supports business sustainability and growth.

There is also a dilemma regarding policy considerations: should the thin capitalization rule be a general rule or a sector-specific one? For example, industries involved in infrastructure projects and manufacturing often require extensive capital; in such cases, a general provision could hinder funding and investment. We must take these challenges into account when adopting a thin capitalization rule.

Overall, when incorporating the thin capitalization rule into the Income Tax Act, we should consider the following aspects:

a) A specific percentage on interest may be more effective than regulating debt through debt-to-equity ratio.

b) The rule should address both related party investments and investments by any entity.

c) It is important to determine whether the provision should be general or sector-specific.

Thank you for your continued trust in us. We appreciate the opportunity to serve your legal needs and look forward to ongoing collaboration.

Yours Sincerely,
The Infinity Partners Team