

# **Towards an Industrialised and Economically Prosperous Nepal**

**An Analysis of the Industrial, Fiscal and Taxation Policies of HMG/Nepal**

**ISSUED IN NATIONAL INTEREST BY**



**NICCI**

**IN ASSOCIATION WITH**



**NBCCI**



**NFCCI**



**NGCCI**



**NUSACCI**

# **An Analysis of the Industrial, Fiscal and Taxation Policies of HMG/NEPAL**

## **Introduction**

**Nepal-India Chamber of Commerce and Industry (NICCI)**, a BI-national chamber, is committed to contribute to growth in Nepalese economy by uplifting the total business environment of the country. The Chamber specializes in creating the required business environment in both Nepal and India to smoothen and simplify the procedures by addressing issues specifically in the areas of Nepal-India trade, increasing Indian Direct Investment into Nepal and servicing its member organizations on issues related to them.

A core area where NICCI is endeavoring to contribute is to increase **Investor confidence, business environment** and resolve issues related to **taxation and various fiscal policies** of HMG. NICCI appreciates the effort of HMG in trying to update the existing laws to the latest international standard in the areas of Industrial Policy, Income Tax, VAT, Customs and other financial acts. The present government along with active participation from the donor agencies has shown keen interest in reforms in these areas which could be clearly remarked from its many commitments in different forums in the past and as indicated in the recent budget.

This has prompted NICCI to take initiatives to put forward the issues concerning the business and industrial sector along with other leading BI-national chambers in Nepal - **Nepal Britain Chamber of Commerce and Industry, Nepal France Chamber of Commerce and Industry, Nepal German Chamber of Commerce and Industry, and Nepal USA Chamber of Commerce and Industry.**

## **The Vicious Circle**

The chambers feel that most of the laws and policies are inconsistent with each other and create hurdles in business growth. These small but practical difficulties lead to loss in business confidence and at times distract businesses from sustainable

growth and good corporate governance. The following cycle depicts the vicious circle the country's economy has to face as a consequence.

- Economic agenda always behind other agenda.
- Non-identification of the strength and opportunity for Nepalese economy
- Frequent changes in policies
- Lack of clarity in laws and regulations.
- Discretionary authority to regulators without commensurate accountability.
- Target-driven Revenue approach.
- Delayed justice mechanism.

*Which leads to*

- Reactive instead of Pro-active approach
- Interpretation invariably against business community.
- Harassment and unreasonable requirements.
- Unethical practices within the system.
- Separate sets of accounts for tax and management purposes.
- Manipulation in tax returns to set off extra liability.

*Which again leads to*

- Non-adequacy of rules and regulations
- Non-compliance of statutory requirement
- Deviation from international accounting standards.
- Inability to meet foreign partner's management standards.
- Protracted litigation. Open-ended liability for tax-payers
- Lack of corporate governance and transparency

**Results into**

- **Rules and regulations in contrast to business practices**
- **Low business morale.**
- **Disincentive to foreign / domestic investors who embrace transparency and good governance.**
- **Tendency to invest in projects with quick paybacks rather than value addition.**

■ **Revenue loss to the national exchequer.**

**Objective**

Overall economic development of Nepal cannot be achieved without parallel growth in industrial enterprises. Industrial growth enables the country to utilise the available resources in the most economical and effective manner, but also increases productivity, generates employment and contributes to the revenue mobilisation of the government. The government realised that industrial promotion cannot be achieved without the private participation as its effort to boost industrial growth through public enterprises have failed. The enactment of the Industrial Enterprises Act, 2049 was commitment from the government for involvement of the private entrepreneurs and foreign investors in industrial development.

The vicious cycle referred to above has curtailed the participation of the local and foreign investors to foster industrial development as various policies brought out by the government, e.g. the fiscal policy, industrial policy, labour policy, monetary policy has failed to attract private participation and foreign investment in industrial enterprises. The situation gets worse as these policies are not cohesive with each other and the other repeals facilities provided by one policy.

To promote industrial growth and create an environment for private participation and attraction of foreign direct investment in industrial enterprises, NICCI, along with other BI-national chambers and its members have identified major problems, its implications and the possible remedies envisaged in the field of aforementioned areas. These issues and solutions are highlighted under the respective areas of concern in the preceding paragraphs and NICCI is confident that the government will address these matters urgently to make industrial investment more congenial, and encouraging for the sustained overall economic development of the country.

**Issues and Concerns**

***Issues relating to industrial growth***

Government regulations and approach towards industries are prone to frequent changes. Investors therefore are unable to take a long-term view on their investments



- Recycling of waste and packaging material is considered to be good for the Environment as well as it saves lot of resources. The system of collecting tax on these items is unique and specific to Nepal only and discourages this noble cause. In many countries, Government pays for the cost involved in recycling of these goods. Moreover, where an Industry with returnable packaging is considered, this practice is very unreasonable and with a single motive to collect revenue only, disregarding Industrial spirit and Environment.
- There are no comparative advantages for any investor whether domestic or foreign to start a business in Nepal when viewed against the benefits available in adjoining states of India, Bangladesh and Sri Lanka. The investment opportunities in these countries and the facilities provided are more attractive than that made available by Nepal. The detailed comparison of some of the significant benefits available in Nepal and those in other countries is provided in the appended Exhibit A.
- One window committee has become ineffective due to lack of co-ordination and competing priorities of the Ministry of Industry and Ministry of Finance. MOI seems interested in facilitating the industrial sector but MOF is hugely revenue-driven and act as a deterrent rather than a facilitator.
- Requirement for commercial banks to raise “paid –up” capital to NPR 1 billion appears excessive given the size of the Nepalese economy and Nepalese Investors. India with a GDP of USD 250b requires commercial banks to meet “core capital” requirement of USD 25 million. The Indian economy is 50 times bigger than ours.
- There is no exit policy for potential foreign investors. The fact that stock exchanges and securities market run on socialistic concepts; management control, issue of shares at premium of exits difficult. Foreign investments can be encouraged only if exit routes are clearly specified.

### **Tax Matters**

The issues and concerns related to the Income Tax Act, 2058 have been broadly classified into the following sub groups:

## ***General issues***

- Language used in the Income Tax Act, 2058 is very complex and ambiguous. This gives rise to misinterpretation of the provisions by the enforcing agents as well as the practitioners to suit their needs as it arises.
- The Act has been professionally drafted and may have addressed certain gray areas in the previous Act. However, implementation of the provisions of the Act will be performed by the same revenue officers who:
  - ❑ Lack proficiency in interpretation of the provisions of the Act
  - ❑ Level of skills and knowledge of law and accounting are very low
  - ❑ Connive with the taxpayers for their personal benefit and that of the taxpayers resulting in revenue leakage.
- The revenue authorities follow the internal circulars issued by the Department for assessing the taxable income of various types of businesses e.g., which require predetermined rate of profit must be earned on the turnover. To achieve this objective, accounts of the taxpayer is either rejected or certain lawful expenses are disallowed or added back indiscriminately. This encourages taxpayer to unethically manage profits and turnover to gap the difference between tax payable and tax paid.
- Due to poor corporate governance in tax administration and lack of defined ethical practices it is experienced in the past that persons and businesses maintaining dubious books of accounts with less or no transparency face less hassles in tax clearance.
- To control and monitor the tax officer's assessment no significant mechanism has been developed except to appeal DG who can also be the assessing authority.

## ***Specific issues***

- Discretionary authority given to the tax department for changing the method of accounting used by the taxpayers if it appears to them that the taxable income

is reduced or deferred under section 21(5) is subject to misuse and harassment to the taxpayers.

- Where Section 21(3) of the Act makes it mandatory to use accrual system of accounting for companies, Section 24(3) gives discretionary power to the tax officer to call payment of more tax on the pretext that accrual basis has decreased the tax liability and the taxpayers would have to pay more tax had he adopted cash basis for tax computation. Such double standards are against Generally Accepted Accounting Principles (GAAP).
- Many provisions of the Act talk about market value of assets and benefits. There are no basis for determining the market value in the Act and the rules framed there under. Further the Act is silent on the standard rate of interest to be used to compute value of perquisites in case of loans given to the employees on subsidized interest rate. Such incomplete information provides the tax authorities to determine the market value of the assets and rate of interest indiscriminately.
- The current Act has conceived the system of pooling of assets but has not addressed the treatment of profit on loss on sale of pooled assets.
- The treatment of the leasehold assets has not been specifically provided in the Act including the treatment of repair and maintenance on such assets.
- The cap provided on repair and maintenance and the basis for computation is not in accordance with the generally accepted accounting principles. The repair and improvement costs that are allowed as deductions should be based on the nature of repair and improvements and not otherwise. The Act should have defined when a repair and improvement would be treated as capital repair and added to the cost of the assets.
- Major repair and improvement costs are incurred in a business generally after three to five years after the assets are put to use. Moreover, such costs vary from industry to industry e.g. entertainment or high tech industry where refurbishment at certain interval is the norm or technological obsolescence require frequent replacement. The new Act has restricted the expenditure

allowed under repair and improvement to 5 percent of written down value of the pooled assets, the limit provided is not at all adequate to absorb the actual repair and maintenance cost. In view of the previous regime of accelerated depreciation given to industries, the new provision poses a graver problem.

- The use of experts by the tax office in assisting the department for reviewing tax returns etc is appreciated. The independence of such expert is vital. The opinion of expert who is part of the tax administration is questionable, as most of the time the interpretation of law is peculiar and biased.
- No criteria has been specified to define what constitutes 'knowingly' or 'recklessly' in filing misleading returns under section 120 that would result in penalties of 50%/ 100%. It leaves a lot of room for subjective judgments.
- The provision of a penalty of 100% of the evaded tax for aiding and abetting a person knowingly or recklessly by another person to commit an offence on evasion of tax or providing counselling or advisory services is unnecessarily harsh.
- No provisions have been made for the pending cases of tax assessment before the commencement of the Income Tax Act. It is not clear whether the taxpayers should go for litigation under section 33 of the old Act or section 115 of the new Act.
- The final delegations are vested with the Director General at all stages of assessment and appeals. Further he is required to meet the target of revenue collection. Under the circumstances, the taxpayer, in spite of having transparent books of accounts, ends up paying additional tax as determined by the authority or has to proceed toward further appeals/litigation.
- Accelerated depreciation at the rate of  $1/3^{\text{rd}}$  of the asset value was previously allowed to all industries. Similarly, second shift charge-off at the rate of  $1/4^{\text{th}}$  of the asset value was also allowed to all industries. These provisions have now been repealed and the  $1/3^{\text{rd}}$  allowance has been made available to a few selected industries only. Such discrimination is unreasonable as all industries contribute to the economic development and, more importantly, the national exchequer.

- Benefits available under the Industrial Enterprise Act, 2049 have been repealed by the new Income tax Act e.g., export earnings have been made taxable at 20% against a much lower rate applied before. This will have a direct impact on the flow of foreign direct investment into Nepal. For the deteriorating economy like ours injection of foreign capital in the industrial sector is imperative, sentiment of which is missing in the Act.
- It is not clear whether any payment in cash above NPR 50,000 for capital expenditure is allowed.
- Income and expenses recognition of an insurance company is governed by separate Act. The new Act has not taken into account the same for determining the taxable income of insurance business.
- Withdrawal of the provision stipulating tax deductibility of premium paid for life insurance coverage has made a significant adverse impact on the viability of life insurance business. Premium paid towards life insurance should be considered an allowable expense as it encourages savings.
- Advance ruling within 45 days and administrative review within 65 days should be mandatory.
- Maximum period for the need to maintain records is open-ended. A specific time frame should be stipulated.
- Capital gains of business are taxed like a normal business income. It does not encourage investment. It should not be taxed if reinvested within specified period. Any amount not reinvested should be taxed at a lower rate.
- Constitution of the Appellate Court is such that the logic of appeal and natural justice is defeated. It should pay due consideration to the seniority, qualification, experience and independence of judges for delivering justice independently and expeditiously.
- The finally assessed files should not be re-opened unless there are concrete evidence of tax evasion. In any case a final assessment should be considered closed for good after 2 years of filing returns.

- Where files have been assessed and settled, the Tax Office should be made accountable to the Auditor General and not the taxpayers to offer explanation for audit discrepancies
- In order to meet revenue targets, the tax department resorts to demanding advance income tax payments from businesses. These demands are usually not proportionate to income or potential tax liability for the period for which such advance is demanded.

### **Possible remedies**

The following are the recommendations to make the tax policies more attractive, user friendly and which provides confidence to the taxpayers and the government. This will enable the government to create an environment where the people will not hesitate to pay taxes thereby increasing the revenue collection. These steps if addressed properly, will also encourage direct investment into the country, which will increase the industrial growth and the economy:

#### *Immediate steps*

- The principles of no taxation without representation should be strictly observed. The change in tax rates or basis of valuation of income should be strictly based on the provisions of law and not on circulars, ordinance or executive order. Any circulars' clarification or interpretation of law must be made through gazette notification. Until any issue is not clarified by gazette notification, benefit of doubt must go to the taxpayers.
- The onus of proof for disallowed expenses or rejection of account should lie with the tax administration and not with the taxpayers.
- The level of skills and knowledge of the staff at the revenue office should be enhanced by continuous training programs. Good governance should flow from top to bottom. Prevention and control of unethical practices at lower levels only will not address the issue.

- Simplify the language for clarity thereby reducing ambiguity in the tax and other laws and regulations.
- The computation of taxable income and tax amount should be done entirely in accordance with the provisions of the Act. This should be applicable for both the taxpayers and the tax authorities at the time of assessing the taxable income. Reliance on internal circulars for ad-hoc determination of taxable income for a particular nature of business is not a fair and transparent practice that is followed by the tax authorities and should be discontinued.
- The authorities must accept the fact that income from business cannot be always uniform and may vary due to so many internal and external forces affecting the business. The tax department should not be given the authority to change the method of accounting for certain payments only with the objective of increasing the tax of the taxpayers. The criteria that should be seen by the tax authorities is whether the taxpayers has been following the accounting methods used consistently.
- No law or regulation should be introduced with a retrospective effect and without proper homework, consultation and education among users and target group.
- When there is an urgent need for foreign direct investment in the country to boost the industrial growth and the economy, the tax authorities should give due consideration to this effect to woo foreign direct investment.
- The person making such deduction must issue TDS certificate in a prescribed format. This certificate should be mandatory accepted as a proof of payment of tax. The onus of deposit of TDS should lie with the person making such deduction.
- TDS or payment to person registered with VAT should be abolished and records maintained for VAT purpose should be accepted for all tax purposes.
- A provision of Direct Tax Commissioner independent of tax collection and administration be made for reviewing tax assessment disputed by the taxpayer.

### *Next steps*

- Gradually replace the existing excess, inefficient, and unproductive staff in various offices/department of HMG with highly qualified professional staffs that have adequate training on revenue systems. A training centre should be established and specialized training should be imparted to prospective staff and officers of joining the revenue services. Only personnel who have undergone specialized training should be appointed under the revenue service.
- Laws and regulations governing different business activities should be respected. Conflicting laws and regulations should be made compatible by amendments.
- Take the investors and business sector into confidence. Suggestions and feedback provided by business community should not go unheeded.
- The ethical practices to be followed by business community and tax officers should be defined and respected.
- Electronic filing of returns and assessment should be encouraged, as it will require less frequent contacts between tax payers and tax administration.

### *Other laws hampering private sector growth*

- Bonus Act has outlived its utility and therefore should be repealed. Moreover, the law is inconsistent with liberal economic policy and international practices. One month of salary may be paid as a minimum bonus during the month of Dasain. It could be included in Labor Act and the Bonus Act must be repealed. All employee benefits including bonuses should be linked with the performance and productivity.
- Provision of housing allocation of 5% of profit under labor law should be repealed as Labor law has specified payment of house rent as a part of minimum wages. Law should not establish norms for distribution of profit, as it is the sole right of investor.



- Introduce saving schemes for individual taxpayers with tax relief to promote savings. More tax incentives for investment in shares and bonds of companies should be provided to individual taxpayers, which will not only boost the capital market but also provide the much needed capital to enterprises.

## **Conclusion**

It can be clearly identified that most of the issues can be resolved even if a commitment from both HMG and Business Community and a well-defined modality to address the Issues is agreed upon. NICCI and other BI-national Chamber of Commerce and Industry believe that it is high time all the stakeholders agree to focus themselves in increasing the economy, which in return shall benefit the Country.

For comments e-mail to: [secretariat@nicci.org](mailto:secretariat@nicci.org)

## Exhibit A

### **Details of Facilities Provided by Other Countries in the SAARC Region for Industries**

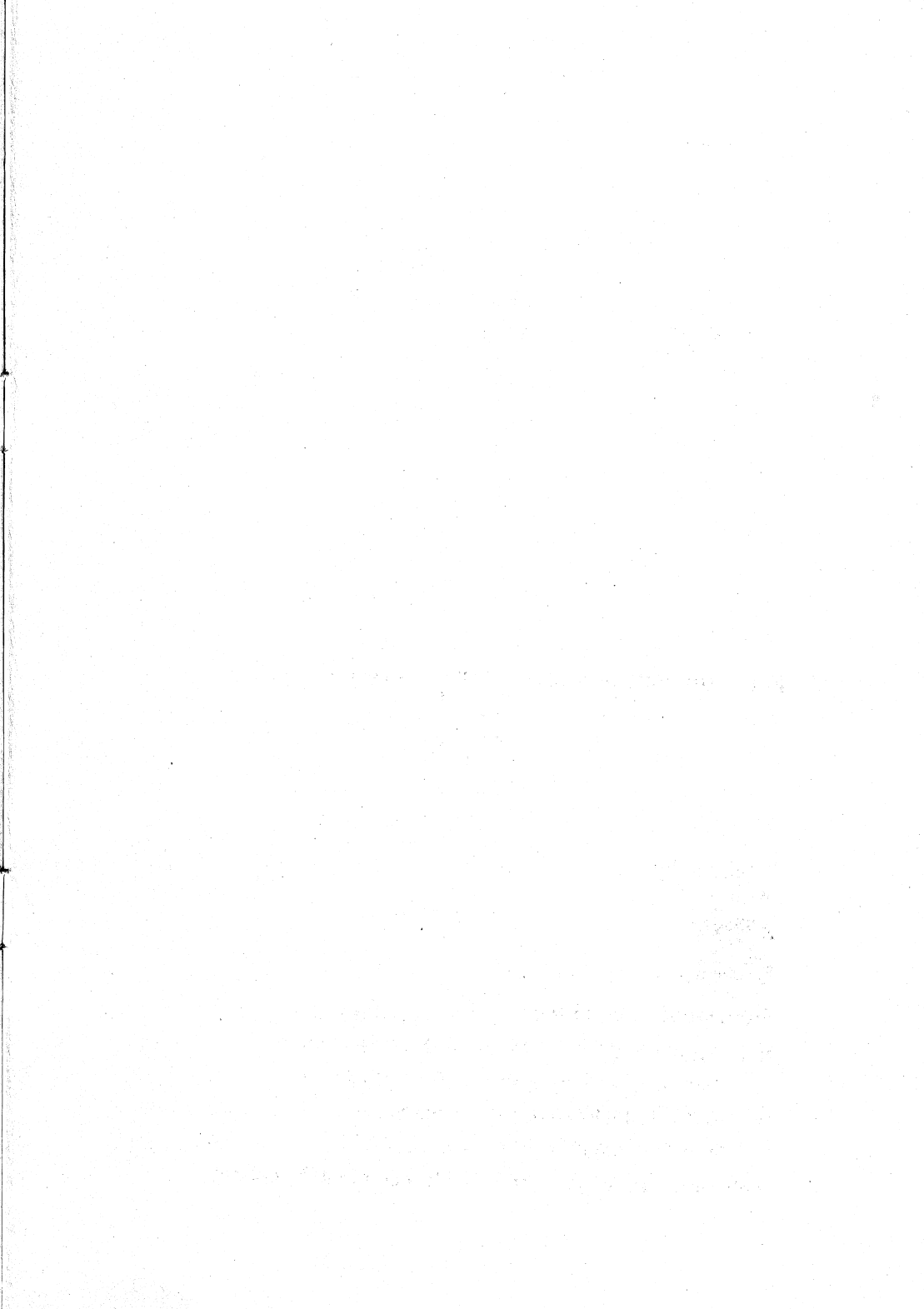
|                                            | <b>Nepal</b>                                                                                      | <b>Bangladesh</b>                                                                                                                                                                                                                                                  |
|--------------------------------------------|---------------------------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>Tax Holiday for New Industries</b>      | None                                                                                              | 5 – 12 Years depending upon location of the industry                                                                                                                                                                                                               |
| <b>Tax on Export Income</b>                | Fully Taxed                                                                                       | Export Income is Tax Free                                                                                                                                                                                                                                          |
| <b>Customs on Export</b>                   | 0.5% to 10%                                                                                       | None, rather subsidy is given                                                                                                                                                                                                                                      |
| <b>Subsidy on Export</b>                   | None                                                                                              | Available in many items up to 25% of export value                                                                                                                                                                                                                  |
| <b>Facility of Export Processing Zones</b> | NA                                                                                                | Very efficient EPZ comparable to western countries                                                                                                                                                                                                                 |
| <b>Domestic Market</b>                     | Population 23 M<br>GDP 6.0 B USD<br>Per Capita Income 240 USD<br>Growth Rate 2-3%                 | Population 131 M<br>GDP 47.1 B USD<br>Per Capita Income 370 USD<br>Growth Rate 5.9%                                                                                                                                                                                |
| <b>Access to Indian Market</b>             | By Air and Land. Mostly limited to Northern India                                                 | By Air, Land and Sea. Even South and West India is accessible                                                                                                                                                                                                      |
| <b>Access to Other Market</b>              | By Air or Land (transit through India or Bangladesh)                                              | Own Seaport allows direct shipment all over the world. Two International Airports                                                                                                                                                                                  |
| <b>Labour</b>                              | Cheap but unskilled. Pro-Labour Law                                                               | Cheap, skilled and Productive. Flexible and balanced Labour Law                                                                                                                                                                                                    |
| <b>Implementation</b>                      | Delayed and high Cost                                                                             | Very easy and with no extra cost in case of EPZ. Otherwise it takes a little bit more time but reasonable                                                                                                                                                          |
| <b>Attraction</b>                          | Tourism<br>Hydropower<br>Developing economy and purchasing power<br>Access to North Indian Market | Better Logistics and Access<br>Attractive Investment Climate and existing huge industrial base<br>Huge and growing Domestic market; good scale of economy<br>Skilled labour, Better Resources<br>Better Public-Private Partnership<br>Hydropower and Petroleum Gas |

### **Facilities given to a new Industry in North Eastern States of India:**

- a. Income Tax: 100% exemption of Income Tax for first 5 years followed by 30% exemption in next 5 years. Industries in specified zones and growth centres receive 100% exemption for 10 years.
- b. Excise Duty: Industries in specified zones and growth centres receive 100% exemption for 10 years. Specified Industries (Plastic, Paper, Agriculture and Forestry Products, etc) enjoy 100% exemption for 10 years even if they are located elsewhere.
- c. Sales tax: Total exemption for 10 years.
- d. Transport Subsidy: Subsidy on freight to and from Siligurhi to the industrial location on all raw materials, Plant and Machinaries, and Finished Goods.

### **Facilities given to a new Industry in West Bengal:**

- a. Capital Investment Subsidy on investment made in fixed capital ranges from 15% to 25%.
- b. Up to 50% of the interest liability is subsidised for a period of 5-7 years.
- c. Up to 75% of contribution made towards Employees Provident Fund and retirement benefits are subsidised.
- d. Up to 50% waiver of duties on purchase of land and building.
- e. Additional subsidy for industries in IT, Electronics, Agro/Food processing, Hydropower, Biotechnology, Tourism, Hosiery, Jute and Agriculture implement.
- f. Cheaper electricity rates for Industries



**For comments e-mail to: [secretariat@nicci.org](mailto:secretariat@nicci.org)**

**Published by**



**Publication Committee,**

**Nepal India Chamber of Commerce and Industry**

**Shahid Shukra Brikshya (Way to FNCCI Building)**

**P.O. Box: 13245, Teku, Kathmandu, Nepal.**

**Tel: 250607, 250642, Fax: 977-1-250642**

**Web: <http://www.nicci.org>, E-mail: [secretariat@nicci.org](mailto:secretariat@nicci.org)**