Key Insights

Thin Capitalization Rules and Taxation in Nepal

Published Date
5th October, 2024

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Concept

1. 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.

2. 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

3. 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

4. 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 obligations 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.

5. 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.

6. 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.

7. 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 a resident 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.

8. 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

9. 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.

10. 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 financing methods, ensuring they pay their fair share of taxes and reducing the incentive for profit shifting.

How are the Thin Capitalization Regulated?

11. 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

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

b) Earning Stripping Rule (Specified Percentage)

13. 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

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

d) Anti-Avoidance Rules

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

Practices in Different Jurisdiction

16. 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	***<u>Application of 'Specified Percentage methode' or 'Earning Stripping Rule.'</u>*** - 30% of earning before EBITDA of previous year or amount of interest paid to associated enterprise previous year, whichever is less. - The excess of above-mentioned condition is regarded as excess interest and disallowed for deduction.
2.	USA	Internal Revenue Code, 1961(Section 163(j)(2)(A)(ii) Introduced Since 1989	***<u>Application of 'Fixed Ratio Rule' or 'Safe Harbour rule'</u>*** - 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).)	***<u>Application of 'Fixed Ratio Rule'</u>*** - Debt equity ratio is 1.5 :1. - The interest allocated exceeding above ratio will be disallowed.

How thin capitalization is regulated in Nepal?

17. 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.

18. 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

19. 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.

20. 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.

21. 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)

22. 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)

23. 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.

24. 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

25. 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.

26. 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.

27. 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.

28. 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.

29. 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 a 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.

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