CHAPTER VIII

CORPORATION TAX IN NEPAL

Introduction :

Individuals either own businesses directly as proprietors and partners, or own them indirectly by holding residual claims against intermediaries, such as corporations, co-operatives and trusts, that carry on business.[1] And the tax which these corporate bodies pay on their income, that is, profit, is being called corporation tax. This tax is not as old as the personal income tax. It was introduced in the revenue regime of the government several decades later than the personal income tax.[2] The corporations are being taxed separately on the ground of their being separate legal entities as persons. The corporations are also taxed on the ground, as Lakdawala observes"if the state finds that in the interests of its subjects, growth of corporations and companies is essential and therefore grants the privilege of incorporation, there is no reason why it should be debarred from taxing the greater earning power it thereby confers on companies."[3] And corporate form of organization is gaining

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1. Report of the Royal Commission or Taxation, Volume 4, Taxation on Income, Canada, 1966, p.214.

2. Lakdawala, D.T., Justice in Taxation in India, op.cit pp.98-99.

3. Ibid., p.94.

importance as a major revenue earning source for modern governments.[4] So it is fully logical to make them liable to pay tax on their incomes.

Personal income tax is a general tax whereas tax on corporations applies only to their capital income. It is limited to capital income which accrues in the form of profits to the corporations.[5] So the distinction between gains of an income nature and gains of capital nature assumes paramount importance in corporation tax.

Corporate income is taxed at two levels. At first level it is taxed when the corporations earn income and at the second level when the corporate income is distributed to the shareholders in the form of dividends. At the first level it is taxed in the name of corporation tax and at the second level it is taxed as personal income tax.[6]

This taxation is also governed by the same Income Tax Act. However, the basic exemption limit is not provided to corporate income as under personal income taxation. Taxing

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4. Report of the Taxation Enquiry Commission, Volume II, Government of India, p.24.

5. Musgrave, R.A. and Musgrave, P.B., Public Finance in Theory and Practice, op.cit., p.397.

6. Report of the Royal Commission on Taxation, Volume 4, op.cit., p.10.

the income of organization is generally regarded as inexpensive method of collecting revenue. As Lakdawala also observes, "corporate income, though a difficult thing to arrive at, is more easily worked out than its capital. A tax on it, therefore, has been greatly favoured."[7]

Definition of Corporate Income :

The definition of corporate income or profit is as established under the recognised accounting practice. The use of the word 'Profit' in the general definition of income of a business organization necessarily means the net income, that is, gross revenue less the costs incurred in producing it. And this net income is chargeable to corporation tax. Though the basic principle of determination of taxable corporate income appears to be simple enough in practice it is not so. Determination of business costs alone poses considerable problems in this regard. Treatment of capital gains, tax exempt securities and charitable contributions are other problem areas in determining the profits of the corporations as in the case of personal incomes. Though the net profit or loss of all corporations is clearly presented in the balance sheet and the profit and loss account which is audited by the certified auditor and is passed by the general body of the concerned corporation, the figures of the profit or loss presented in these documents

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7. Lakdawala, D.T., Justice in Taxation in India, op.cit., p.98.

may not necessarily be acceptable for tax purposes. These figures can, by no means, be taken for granted. The method and rate of depreciation of different physical assets for tax purposes are given under all income tax systems. Some allowances might have been provided in the form of development rebate or investment allowances with an objective of encouraging investments in certain specified areas. Moreover, only business expenses which are incurred in producing income are allowed to be deducted while determining net profit of corporations. Valuation of stock-in-trade should also have to be done in accordance with the prescribed method. And there exists every possibility of passing personal expenses of corporate executives on business expenses and lavish and wasteful expenses in the management itself. So only after examining all these calculations and expenses carefully as to whether these have been done as per income tax laws and rules or not, the net profit or loss of a corporation can be established for income tax purpose. The principle of determining the taxable income is, however, the same whatever be the status of tax payer, be it company, individual, partnership or co-operative society.[8]

Test of Business Expenses :

There are mainly three criteria on the basis of which the expenses incurred by the corporations in producing income

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8. Final Report on Rationalization and Simplification of the Tax Structure, Government of India, Ministry of Finance, India, 1967.

are allowed or disallowed to be deducted while determining the net profit of the corporations, as follows:

a. It should be wholly and exclusively laid out or expended for the purpose of business;

b. It should not be of a personal nature; and,

c. It should not be of a capital nature.

Though, expenses only wholly and exclusively expended for the business are regarded as business expenses,[9] in almost all the income tax systems there exist ample room for controversy regarding almost every item of expenditure incurred by the corporations. As for example, expenses incurred in rent, repairs, interest payment, remuneration paid to employees, transport and travelling expenses advertisements, sales costs, commissions etc. are listed in every income tax laws as deductible expenses. But mere listing does not solve the problem. In all these items of deductible expenses, the corporation may add some unreal or non-deductible expenses and even if only real and necessary expenses are claimed, the tax authorities may question the reasonableness of the magnitude of certain expenses.

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9. Gulati, I.S. and Bagchi, Amaresh, "A Proposal for Reforming Corporation Tax", Economic and Political Weekly, An Annual Number, February, 1975, p.201.

Another important problem with respect to the determination of business expenses is that there exists ample room for passing personal expenses of the corporate executives on the business expenses. Corporate nature of business organization itself encourages such tendency. As Gulati and Bagchi observe, "it comes out that the stake in economising becomes smaller as the ownership of a firm becomes more diffused. The stake is found to be lowest for the most widely held public limited companies."[10] It is because that the real owners (shareholders) of companies, specifically, the public limited companies are many and hence they have far less say in the functioning of the companies. So, even if they are not satisfied with the management, they prefer to sell their shares rather than to voice their grievances. As Gulati and Bagchi have rightly stated - "the financial stake of persons in control of business firms can be quite low and that personal gains to them from Camouflaging personal expenses as business expenses could be quite considerable."[11]

In the same way, expenses of capital nature may also be claimed as business expenses, in order to avoid taxation. The distinction between current business expenditure and capital expenditure is frequently difficult to draw and has caused, and

10. Ibid., p.195.

11. Ibid., p.197.

is continuing to cause, confusion and uncertainty among tax payers and tax authorities.[12] As for example, certain repairs of buildings, machinery and/or automobiles which may increase the longivity of the assets or improve the capacity or efficiency of the assets are of capital nature. In the same way expenses incurred in some types of training provided to personnel may be of capital nature but still may be claimed as business expenses. There may be several other expenses which might have been incurred for the enhancement of the capital but may be claimed as business expenses.

It is out of this difficulty in ascertaining the real business expenses that there occurs constant, controversy between the tax payers and tax authorities which also results in growing number of litigations. All these factors have, finally, led to lavish and wasteful expenses in corporate sector. This problem of lavish and wasteful expenditure combined with strong tendency of retention of profits by corporate sector (particularly by closely held companies) to avoid double taxation has provoked some experts to suggest the replacement of the corporate tax base by corporate expenditure instead of corporate profits.[13] And this has

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12. Report of the Royal Commission on Taxation, Volume 4, op.cit., p.229.

13. See, Gulati, I.S. and Bagchi, Amaresh, op.cit., p.195., and Lall, V.D., "Changing Corporate Tax Base", Economic and Political Weekly, March 22, 1975, p.531.

also led governments to levy tax on undistributed profits."[14]

Another problem regarding the corporation tax is that the nature of activities in which the companies are engaged in are not similar. Some may be involved in industrial enterprise, some may be in trading business, others in mining and petroleum, banking, insurance, transport, hotels etc. Ascertaining income/ profits in these diverse activities cannot be reduced to uniform simplicity. So the tax system should, unavoidably, take care of all these factors while determining the business expenses.

In this background, we will make an attempt to examine the case of corporation tax in Nepal, specifically in the following areas:

a. How is the structure of corporate sector in Nepal?
b. How the corporate sector is being taxed in Nepal? and,
c. How productive the corporation tax has proved in terms of revenue in Nepal?

Corporate Sector in Nepal :

Corporate sector is in its early infancy in Nepal. Whatever corporate sector exists in Nepal is either fully

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14. Lakdawala, D.T., Justice in Taxation in India, op.cit., p.101.

government owned or partially government owned. Very few of the companies are in private sector. Almost all the fully or partially government owned corporations have been enjoying monopoly power in their respective fields. But still, they are yet to earn profits on a significant scale. The main reason behind this, might be that majority of these corporations are either development oriented or service oriented. As for example, development banks (agriculture and industry), commercial banks, transport (air and surface) eletricity, drinking water, telecommunication, agricultural inputs and even trading of food, salt, sugar, firewood, timber etc. which are either fully or partially government owned are either development or service motivated. So, they are heavily subsidised every year by the government instead of earning profits. Very few of such companies or corporations are profit motivated. The companies with mainly profit motive include production oriented companies such as cement, sugar, cigarettes, drug, brick and tile, leather and shoe, milk, textile, school level textbooks etc. In these areas, the government has monopoly ? in their production and distribution. In others, government has played only participatory role. And more than 95 per cent of the revenue from corporation tax comes from these government owned companies alone in Nepal. Public or private companies outside government sector are almost non-existent in Nepal. And whatever public or private companies are there, these are mainly confined to hotel business, textile, brewery, surface transport, and some other areas of negligible importance. Another interesting feature of the corporate sector in Nepal is that the shares of the government owned companies are either with Nepal Rastra Bank (equivalent of the Reserve Bank of India) or other financial institutions such as Employee's Provident Fund, Commercial banks etc. Capital market is yet to be created in Nepal. Majority of the economic activities related to industry, business, profession or vocation are scattered in small units and are being carried on a proprietorship or partnership basis.

Corporate Sector from the Point of view of Taxation in Nepal :

The Corporations and companies are generally classified in one group and partnership firms and firms are in another group for income tax purposes. Corporation tax applies to former group while personal income tax applies to latter group. But the case is different in Nepal. Corporation tax applies to all of them. As a matter of fact, there exists hardly any difference between corporation and personal income tax in Nepal except for exemption limit and surcharge. Corporation tax payers except firms are not granted basic exemption limit. Even partnership firms are denied this exemption. And corporations and companies are liable to pay surcharge on the profits of trading business. The corporations and companies involved in industries are exempt from surcharge. Partnership firm and firms are also exempted from surcharge. Firms are granted basic exemption limit. So corporation tax in Nepal refers generally to tax on the profits of corporation, company, partnership firm and private firm except when the issue of exemption limit and surcharge comes.

Corporate Income Defined :

Since the corporation tax is also governed by the same Income Tax Act, the Corporate income is also defined in the same way as personal income from Industry, Business, Profession or vocation. Income Tax Act 1974 has defined this income in the following words -

"the income shall include all profits or gains from such industry, business, profession or vocation".[15]

The manner of computing the gross revenue and the deductible and non-deductible expenses as already discussed in Chapter III relating to the computation of "Incomes from Industries, Business, profession or vocation" is wholly and identically applied to the computation of corporate income for taxation purposes and therefore need not be repeated here.

15. Income Tax Act 1974 (including amendments), Government of Nepal, p.6.

The most important feature of the corporation tax in Nepal is that the dividend income is not taxed at the hands of the shareholders. It is not included in the total income of the shareholders for income tax purpose. In this regard, Income Tax Act says - "any share received by every partner of a firm or company out of profit of such firm or company on which tax has been paid shall be exempted from tax."[16] The objective of this exemption is obviously to encourage the savings of the corporate sector[17] vis-a-vis the capital market. And this provision is applicable not only to both the public and private companies but also to partnership firms which seems to be most generous and almost unusual provision under any income tax system in modern states. But such generous tax policy towards the corporate sector has not shown any encouraging inpact upon the promotion of the private corporate sector in Nepal.

Provision of Depreciation :

The Income Tax Act of Nepal as elsewhere has maintained that depreciation of physical assets used in business is included in the business expenses and hence is a deductible expense. Accordingly, the methods and rates of depreciation have been specified in the Income Tax Rules, 1982.

16. Income Tax Act 1974, op.cit., p.30.

17. Tiwari, Narayan Raj, Income Tax System in Nepal, op.cit., p.42.

Basically, there are two methods of calculating depreciation of the assets : diminishing balance or written-down value method, and, straightline or fixed instalment method.

Prior to 1982 tax payers were left free to calculate depreciation at prescribed rate by following either of these two methods.[18] But Income Tax Rules, 1982 has prescribed only diminishing balance or written down value method to calculate the depreciation.[19]

The rate of depreciation for different kinds of assets have been specified on the basis of the nature and durability of the assets. Accordingly, Income Tax Rules, 1982 has classified the assets into four groups and has specified different rates of depreciation as follows:

a. Buildings - 2 to 6 per cent

b. Means of transport - 7 to 25 per cent

c. Furnitures - 8 to 15 per cent

d. Machinery - 5 to 25 per cent.[20]

Method of Stock Valuation :

Valuation of stock-in-trade is regarded important as well as one of the most complicated exercise in determining the

18. Tiwari, Narayan Raj, op.cit., p.96.

19. Income Tax Rules-1982, H.M.G. of Nepal, 1982, pp.38-39.

20. Ibid., p.56.

profit or loss of industry, business, profession or vocation. As has been said - "the valuation of stock-in-trade has a considerable bearing on the determination of gross profits as these profits being the result of trading operations, can properly be determined only by taking into account the terminal values of stock-in-trade, purchase (or manufacturing costs), sales and certain charges specially related to these operations."[21] For companies, valuation of stock-in-trade is legally obligatory even without taking taxation into account. Because, the total values of the opening and closing stock should be, unavoidably, shown in the profit and loss account of the concerned company. This being so, the Income Tax Act or Rules have not prescribed any method of valuation of stock-in-trade.

'Cost or market price whichever is lower' is a commonly followed method in stock valuation and in Nepal also this method has been followed. This method includes two such methods such as (a) the pick and choose method, and (b) the global method. In both methods, each item of stock is valued separately at market price and cost price. In the former, the lower of two values is adopted for each item separately, and the total value arrived at. In the latter, the lower of the total value of cost basis of all items and on market price basis for all items is taken.[22]

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21. Report of the Taxation Enquiry Commission, Volume. II, op. cit., p.52.

22. Ibid., p.54.

The method followed in the stock valuation assumes much importance in time of rising prices. During the period of inflation an appropriate method for stock valuation would be 'last-in, first out' (LIFO) method. According to this method, the last article purchased is presumed to be consumed first, with the result that in a period of rising prices tax payers are able to set-off against their sales of the high price paid in the latest purchase and value the unsold stock at the end of the year at the lower price paid earlier.[23]

But no such advanced method of stock valuation has been followed in Nepal. Tax payers have followed simply 'cost or market price whichever is lower' method and in this also, most of the tax payers are found to have followed the cost or purchase price while valueing the stock-in-trade. But there is one restriction in this regard as to whichever type of price, the tax payers choose, they should follow that same type of price in all subsequent years. They may change the type of price only by the permission of tax officer.

Carry-forward or Backward of losses :

In every income tax system, there is a provision of setting-off of loss incurred in any industrial enterprise, business, profession or vocation by either carrying it backward or forward. Carry back of losses implies adjustment of losses

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23. Ibid., p.54.

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against income earned in the past upto a prescribed number of years. The taxable income, and tax liability, for the years affected are re-calculated, and the consequent refund of tax is allowed to the tax payers. In the carry forward system no refund is involved; tax relief takes the form of a reduction in the taxable income of the future years.[24] And the losses incurred in one source of income should, generally, be set-off from the income of the same source. But in case of Nepal, no such comprehensive and refined system of off-setting of loss has been evolved and followed. According to Income-Tax Act the loss incurred in any industrial enterprise, business, profession or vocation is deducted from the net income in the following year and if the loss could not be set-off from the income of that year, it can be carried forward up to two years. In otherwords, loss incurred in one year can be carried forward up to three years. And it is also mentioned that losses incurred in industry, business, profession or vocation can be carried forward and set-off only from the incomes of this source.

Exemption limit, Income slabs and Tax Rates :

Till 1964-65 corporation tax payers also were provided with basic exemption as personal tax payers. But it was withdrawn in 1965-66 and since then no such exemption limit has been granted to the corporation tax payers.

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24. *Ibid.*, p.68.

So far as the income slabs and marginal tax rates for corporate sector is concerned, these were similar to those of the personal income tax payers till the year 1966-67. Even after that, these were similar for both types of tax payers except in 1967-68, from 1976-77 to 1978-79 and since 1983-84. The structure of income slabs and corresponding marginal tax rates applicable to firms, companies and non-residents are presented in Table VIII-1 below.

If we compare the number of slabs and marginal tax rates of corporate sector with that of personal sector (Chapter III, Table III.2) in recent years specifically since 1983-84 we find that the number of income slabs for corporate sector is more than personal sector. And lowest marginal rate for corporate sector is lower than that of the personal sector but highest rate is similar for both.

From this it becomes clear that personal sector and corporate sector are treated almost similarly in terms of progressiveness of tax in Nepal. Not only this, firms, companies and non-resident tax payers are treated exactly alike since as early as 1976-77 from the point of view of taxation. They are taken as one group and income slabs and corresponding marginal tax rates applicable to them are the same ever since 1976-77. It was only since 1980-81 that a surcharge at the rate of 5 per cent was levied on the profits of companies involved in trading and for non-resident tax payers the rate of surcharge

TABLE VIII-1

Income Slabs and Marginal Tax Rates for Corporate Sector (1967-68 to 1984-85)

(In Rupees)

Year	1	2	3	4	5	6	7	8	9	10	11
1967-68	10,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	5,000	Balance
	7	8	10	13	15	17	21	26	32	37	45
1968-69 to	10,000	10,000	10,000	10,000	Balance						
1974-75	7	10	20	35	55						
1975-76	5,000	5,000	10,000	10,000	10,000	5,00,000	Balance				
	7	10	20	30	40	55	60				
1976-77 to	10,000	10,000	10,000	2,00,000	5,00,000	Balance					
1977-78	10	20	30	40	45	51					
1978-79	10,000	10,000	20,000	50,000	1,00,000	Balance					
	10	15	25	35	45	51					
1979-80 to	5,000	5,000	10,000	20,000	20,000	30,000	Balance				
1981-82	5	10	15	20	30	40	50				
1982-83	5,000	5,000	10,000	20,000	20,000	30,000	4,00,000	Balance			
	5	10	15	20	30	40	50	55			
1983-84 &	5,000	5,000	5,000	10,000	15,000	15,000	30,000	2,00,000	Balance		
1984-85	5	10	15	20	25	30	40	50	55		

Source : Finance Arts (1959-60 to 1984-85), op.cit.

Note : Figures below the income slabs are corresponding marginal tax rates.

was 7 per cent. It was raised to 10 and 12 per cent respectively in 1983-84.

Unusual Features :

Whereas corporate income in other countries is taxed at the flat rate without any progression on the ground that - "as the special ability resulting from benefits of incorporation can not even be roughly measured, it is best not to apply the progressive principle to a tax on corporate profits.[25] However, in Nepal, as seen earlier, on the contrary, corporation tax is more progressive than the personal taxation. The rate structure is same for public and private companies and companies involved in whatsoever activities without regard to their nature and importance in the economy.

Another striking deficiency contained in the corporation tax in Nepal is that this tax has not been used as a fiscal instrument to direct investment in the priority area for its growth. No such incentive measures in the form of development rebate or investment allowance have been granted to any kind of corporate investment in Nepal as in India and other developing countries. It has been used as simply a revenue raising device. Even this inference is, doubtful on the ground that companies with smaller profits pay tax at lower rates due to progressive tax structure. More revenues would have been raised from corporate structure if they had been taxed at flat rates because

25. Lakdawala, D.T., Justice in Taxation in India, op.cit., p.99.

corporate bodies with smaller profits also would have paid tax at the same rate as those with larger profits. But under progressive rate structure corporations pay less tax because low rates of tax apply in lower brackets. So it may be stated as conclusion that corporation tax in Nepal is being administered without any clear direction.

Revenue Productivity of Corporation Tax :

The receipts from the corporation tax was not being shown separately till 1976-77. It used to be included in the total receipts from income tax. It is only since 1977-78 that it is being given separately. Receipts from public enterprises, semi-public enterprises, and from private corporate bodies have also been given separately. Receipts from these different corporate bodies during 1977-78 to 1983-84 is presented in Table VIII-2 below.

TABLE VIII-2

Revenue from Corporation Tax in Nepal

(1977-78 to 1983-84)

Year	Percentage Share			Total Revenue from Corporation Tax (Rs. 000's)
	Public Enterprises	Semi Public Enterprises	Private Corporate Bodies	
1	2	3	4	5
1977-78	73.2	14.2	12.6	4,72,93 (100.0)
1978-79	81.4	15.8	2.8	3,30,94 (100.0)
1979-80	74.2	20.0	5.8	3,78,28 (100.0)
1980-81	95.8	1.9	2.3	4,27,88 (100.0)
1981-82	98.7	0.8	0.5	3,79,38 (100.0)
1982-83	96.7	2.8	0.5	5,52,04 (100.0)
1983-84	95.5	3.3	1.2	6,67,40 (100.0)

Source : Budgets in Nepal (1951-52 to 1981-82), op.cit.

It is seen in the Table that more than 95 per cent of the total receipts of corporation tax has been coming only from government enterprises since 1980-81. It proves the virtual non-existence of the private corporate sector in Nepal and poor performance of the public enterprises as can be seen from the figures that even in 1983-84 corporation tax netted only Rs.6.7 crores.

Place of Corporation Tax Revenue in Revenue Structure of Nepal :

Comparison of the revenue from corporation tax with total direct tax revenue, total revenue, and finally with Gross Domestic product will further determine the place of the corporation tax in the revenue structure of Nepal. This comparison has been presented in Table VIII-3.

TABLE VIII-3

Place of Corporation Tax Revenue in the Revenue Structure of Nepal

(1977-78 to 1983-84)

Year	As % of Direct Tax Revenue	As % of Total Tax Revenue	As % of Total Revenue	As % of G D P
1	2	3	4	5
1977-78	13.6	3.8	3.0	0.2
1978-79	11.0	2.2	1.8	0.1
1979-80	12.5	2.5	2.0	0.2
1980-81	9.8	2.1	1.8	0.2
1981-82	7.9	1.7	1.4	0.1
1982-83	9.4	2.3	1.9	0.2
1983-84	9.4	2.4	2.0	0.2

Source : Calculated from Tables I.5; I.6 and I.7.

The Table shows that the revenue from corporation tax has never reached 15 per cent of even direct tax revenue. In recent years it has constituted even less than 10 per cent of the direct tax revenue. As a proportion of the total tax revenue, it has never constituted even 4 per cent and as a proportion of total revenue barely 2 per cent. As a fraction of GDP it is 0.2 per cent. This position is not likely to improve unless the over all performance of this sector improves significantly and the corporate sector itself develops substantially.

Corporate Tax Revenue in Nepal in Comparison to that of Other Countries :

The position of the corporation tax in Nepal becomes more clear if we compare it with that of other Asian developing countries. The comparison is presented in Table VIII-4 below. Comparison is in terms of percentage of total tax revenue and Gross Domestic Product collected by way of corporation tax. The Table makes it abundantly clear that corporation tax in Nepal has so far played a far too insignificant a role in her revenue structure as compared to any other selected Asian developing country except Bangladesh.

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TABLE VIII-4

Position of Corporation Tax Revenue in Selected Asian Countries

Country	Year	As % of Total tax Revenue	As % of Gross Domestic Product
1	2	3	4
Bangladesh	1979	0.49	0.04
Nepal	1982	1.71	0.1
India	1982	12.90	1.6
Srilanka	1982	13.48	2.5
Indonesia	1982	74.61	16.5
Philippines	1982	13.32	1.5
Thailand	1983	10.60	1.5
Korea D.R.	1983	11.80	2.3

Source : a) For Revenue Data - Government Finance Year Book, Country Tables, International Monetary Fund, 1984.

b) For Gross Domestic Data - International Financial Statistics, Year Book, Country Tables, International Monetary Fund, 1985.