



Quick Overview on
Taxation of Permanent Establishment “PE”
Of
Foreign Companies in Nepal

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A. General Summary

1. Foreign company after winning the international bidding contract of Government of Nepal or the state owned enterprises like Nepal Electricity Authority, Nepal Telecom or directly through different ministries like Ministry of Irrigation, Ministry of Education, etc (All referred as "GoN" for understanding); registers **Permanent Establishment "PE"** in Nepal to execute the contract. Most of the contracts are of such a nature that includes two portions;
 - a) Portion of services and supply in Nepal from Nepal in Nepali (NPR) currency
 - b) Portion of supply directly from parent company of PE in foreign currency
2. Nepal PE then issues sales invoice to GoN including the Value Added Tax (VAT) for the portion of NPR i.e. local currency. GoN deducts **1.5% TDS** and deposit in the PAN of PE which can be claimed as advance tax payment for final tax settlement of PE.
3. Currently for the foreign currency portion, GoN directly imports supplies from the parent company of PE and transfers foreign currency directly to parent company. GoN deducts **5% tax** of such import out of payment of foreign currency and pays to Income Tax Office. Similarly, applicable taxes on import like duties and VAT are also paid by GoN. Such taxes including duties and VAT are not allowed to claim as advance tax by PE due to lack of deposit of such taxes including duties and VAT in PE's PAN. Also, GoN imports such supplies in its own name and does the custom clearance.
4. Current Practice

Due to the nature of executing contract in the above manner, PE in Nepal recognizes local currency portion only as its income of any financial year of Nepal for which it issues sales invoices to GoN. The foreign currency portion is left out.

B. Law of Nepal

1. Income Tax Act 2058, the income tax governing law of Nepal clearly states that all the portion of contract (local or foreign) are taxable in Nepal based on the principle that single contract was awarded to the single foreign company to be executed through its PE in Nepal. So both local and foreign currency portion of income shall be included in the income of PE for any given financial year.

RSA had already raised this concern to all the concerned foreign contractors time to time based on the Income Tax Act of Nepal even if the practice was against the general practices. Now, the Income tax Department has issued an official circular stating the foreign portion of contract is also part of income of PE in Nepal and shall be taxed as prescribed. 1.5% TDS shall be deducted and deposited in PAN of PE instead of 5% tax. Such 1.5% TDS can now be claimed as advance tax by PE. [Refer pdf 101 for circular issued]

2. PE should have issued its sales invoices to GoN for both local and foreign currency portion for its income recognition. Cost of supplies by parent company would be cost of PE in Nepal against income of foreign currency portion. The import shall be done by PE from its parent company in its own name to form basis for the cost.
3. **VAT Act 2052, the separate law governing the Value Added Tax (VAT) states that all the transactions dealing with VAT applicable items as prescribed in the VAT Act 2052 of Nepal shall be done including the VAT portion.** VAT is not applicable only in the cases either supply is VAT exempt as per VAT Act 2052 or VAT exemption is provided to PE by Government of Nepal for the supply while awarding the contract.

C. Problems and Complications

1. Income Tax Department has issued circular to deduct 1.5% TDS and include foreign currency portion as income of PE.

2. **Income Tax**

Income Tax Department has issued circular that PE shall be allowed to recognize cost of supply from its parent company as cost of PE. But the tax department has not circulated any basis for the cost recognition. As per Income Tax Act 2058 of Nepal, purchase or consumption without tax invoice is not allowed for cost recognition. Import documents (commercial invoice and pragyapan patra) forms the basis for cost recognition in case of import of supplies from foreign land. In this case, PE has not imported in its name and import documents are in the name of GoN. Claiming such cost of supply as cost of PE could be subject to tax office objections in light of existing provisions of income tax laws.

3. **Value Added Tax (VAT)**

Supply, installation and execution of contract is VAT applicable item (except for supplies that are VAT exempt). If income is to be recognized of foreign currency portion then 13% VAT is applicable (in the same manner as of local currency). If 13% VAT is assessed for income as VAT payable (Output claim) then VAT paid during import should be claimed as Input claim. Excess amount of Output over Input is to be paid by PE. In current situation, VAT paid during import cannot be claimed as Input because (a) VAT is paid by GoN and (b) import is not in the name of PE.

VAT Act 2052 has provision that government entities while making payment of contract shall deduct 30% of VAT amount and deposit in the VAT Account of PE (in practice for local currency portion). **Such 30% VAT deposit responsibility transfers to PE in case of GoN makes full payment of VAT. In the case of foreign currency portion, PE shall be responsible ultimately.**

Frequently Asked Questions (FAQs)

1. Is this provision applicable for income year 2021-22?

YES. Since this is the provision clearly stated in Income Tax Act 2058 from the very beginning, it is applicable for the fiscal year 2021-22 and onwards.

2. What will be case for foreign currency portion for payment already done before the income year 2021-22? Say till 2020-21?

Tax officer has full authority to assess the non-compliance of Income Tax Act and VAT Act for last 5 financial years and up to past 6 financial years in case of fraud assessment by tax officer in special circumstances only.

3. Will there be tax liabilities for foreign currency portion for payment already done before the income year 2021-22? Say till 2020-21?

As the matters have been circulated by the Income Department itself; now there can be high chances of assessment by tax officer based on this matter. Income tax liabilities may arise as per the assessment by the tax office and we believe PE will be given every opportunities to submit their clarifications and documents stating their claim. If tax liability is assessed based on the income of foreign currency portion then supply from parent company needs to be assessed as cost of PE. In that case, we believe 5% tax earlier deducted should be allowed for advance tax claim by the tax officer. Excess of income tax liability assessed over 5% tax along with applicable interest and fine shall be net income tax liabilities of PE.

This is the general principle of tax assessment in accordance to the Income Tax Act. How the tax department will prosecute on these matters is yet to see.

4. What about the VAT payment before the income year 2021-22? Say till 2020-21?

General principle of VAT assessment is same as of Income Tax. Assessment of Output VAT (on Sales) and Input VAT (on Cost) and payment of excess of Output VAT over Input VAT including applicable interest and fines.

This is the general principle of tax assessment in accordance to the VAT Act. How the tax department will prosecute on these matters is yet to see.

5. How PE shall include income of foreign currency part in fiscal year 2021-22?

RSA cannot recommend certain accounting principle right now for income recognition of foreign currency part in FY 2021-22 for want of clarity of concept in GoN and tax department. Income will also attracts concept of cost, VAT and tax liability simultaneously. In overview, PE can prepare its complete statement of foreign currency payment details and submit an application to its registered tax office for further clarification.

In our view, PE should ask GoN to do ETDS of 5% tax deducted out of foreign payment portion in the PE's PAN so that in case of future tax liability assessment such tax can be claimed as advance taxes.

View of Inland Revenue Department, Policy Department, during RSA visit for clarification:

PE is a branch of its parent company to execute the contract in Nepal. So commercial invoice issued by the parent company can be considered as the sales invoice of PE for income recognition. The cost incurred by the parent company can be allowed to recognize as cost to the PE. However, they did not clarify the matters of VAT applicability.

In our view, it could be contrary to the general income tax provisions applicable as per the Income Tax Act, VAT Act and related tax laws. PE is a separate legal entity for income tax purposes. Entities are not allowed to do sale and purchase transactions without issuing/receiving tax invoices.

RSA Views:

Section 68 of Income Tax Act 2058 clearly states that for income tax assessment, PE and its parent company are two separate legal entity for tax applicability. PE cannot claim certain payments to parent company as its cost particularly like interest payment against loan from parent company, royalty payment for use of trademarks or copyright of parent company and any business or management fees paid to parent company which further clarifies the matters.

6. Can PE do as per the verbal communication or verbal consultation of tax officer for FY 2021-22?

NO. *It is not recommended to proceed contrary than as prescribed in the Income Tax Act 2058 of Nepal. It is recommended that PE submit application to its registered tax office for method of income recognition and obtain written clarification from the tax office for future references.*

7. What can PE do in the case of tax office does not provide any clarification for FY 2021-22?

RSA has no any definitive way out about this matter in that case. However, point (b) of below mentioned scenarios can be deemed in compliance to the Income Tax Act and VAT Act of Nepal.

In worst case scenario, PE has only two alternatives;

- a) *Do not include foreign currency portion as income like prior years and keep copy of application submitted to tax office for future references. Risk involved is tax assessment in future by tax officer as described in FAQ No. 3. There will be no any VAT applicability.*

OR

b) *Include foreign currency portion as income of PE. Recognize cost of supply from parent company based on independent market price basis (arm's length basis of transfer pricing). Claim 5% deducted tax as its advance tax (Make sure 5% tax is deposited in PE's PAN). In case of VAT, Output VAT assessment as per the income recognized from the foreign currency part and Input VAT assessment as per VAT paid by the GoN at custom point during import of equipment. PE shall pay excess Output VAT over Input VAT.*

8. Can PE adjust its current excess VAT (due to 30% VAT deposit) against the VAT payable raised from the following FAQ 7 (b) for FY 2021-22?

YES. *Since, 30% VAT deducted and later paid on VAT account of PE out of local currency is deemed payment of VAT by PE itself, such can be utilized for the payment of any kind of VAT payables.*

9. What will be accounting method to be followed from FY 2022-23?

It is recommended to PE that it comply with the Income Tax Act and VAT Act of Nepal. PE shall issue sales invoice to GoN for foreign currency portion as well (in the same manner like of local currency). GoN shall deduct 1.5% TDS which can be claimed as advance tax payment of PE (in the same manner like of local currency). GoN shall release payment to PE in Nepal. PE shall procure from its parent company and import in its own name. GoN shall deduct 30% of VAT amount as prescribed. PE shall pay excess of Output VAT on Sales over Input VAT paid on purchases and procurements and that of 30% VAT deposited by the GoN. PE then shall pay its parent company the cost of procurement after deducting 5% tax.

In the case of specific written instruction from the tax office regarding this matter, PE shall follow the same method of executing its contract.

10. Since parent company will issue commercial invoice to PE; can parent company charge higher cost so that income tax liability of PE can substantially decrease?

Case of deducing the tax liabilities knowingly or having such similar arrangements deliberately; comes under tax avoidance scheme. It is illegal according to the Income Tax Act and Vat Act of Nepal. There are provisions for fine and penalties for such deeds. PE shall also consider that;

- a) *Duties to be paid at custom point is based on the market price or declared price whichever is higher. Custom officer has authority to assess such price at his/her discretion.*
- b) *Income Tax Act and VAT Act of Nepal clearly states that PE and its parent company are related parties. Transactions between the related parties shall be governed by the transfer pricing model (at arm's length price between any two independent parties). Moreover, tax officer has authority to assess the transfer pricing between the related parties and assess additional applicable income tax and VAT.*

11. What if GoN denies to accept the sales invoice from PE and payment to PE for foreign currency part?

RSA has not any definitive way out regarding this matter. PE shall consult its related GoN regarding the tax issues facing by the PE. However; as per the circulation from the Income Tax Department, GoN now shall deduct 1.5% TDS and deposit in PAN of PE. In that case, GoN may ask PE to issue sales invoice. It is strongly recommended to consult with GoN immediately regarding the matter for FY 2022-23.