Taxation and Investment Decisions in Nepal: History, Role, and Challenges

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Abstract

Taxation plays a significant role in shaping investment decisions in Nepal by influencing the cost, return, and risk associated with economic activities. This study examines the historical evolution of taxation, key challenges in the current system. Nepal's tax system has developed from traditional in-kind contributions to a modern framework guided by the Income Tax Act, 2058. At present, tax revenue contributes over 90 percent of total government income, making it a critical instrument for economic planning and development. Tax policies, including corporate income tax rates, sector-specific incentives, tax holidays, and depreciation allowances, directly affect investment behavior. Recent reforms have introduced favorable provisions for priority sectors such as information technology, startups, and manufacturing, encouraging both domestic and foreign investment. These incentives help reduce business costs and promote long-term capital formation. Despite these improvements, the taxation system in Nepal faces several challenges, including complex procedures, lack of taxpayer awareness, administrative inefficiencies, corruption, and weak digital infrastructure. These issues discourage compliance and limit investment potential. The study concludes that simplifying tax policies, enhancing transparency, strengthening administration, and improving digital systems are essential to creating a more investment-friendly environment and supporting sustainable economic growth in Nepal.

Keywords: taxation, investment decisions, tax policy, revenue mobilization, tax compliance

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Introduction

Government revenue comes from two sources: taxes and non-tax revenue. Income tax, property tax, value-added tax, excise duties, customs duties, etc., fall under the head of tax revenue. Revenues such as gifts, grants, income from public enterprises, and administrative revenue, such as registration fees, fines, and penalties, fall under the head of non-tax revenue. Among the different sources of revenue in Nepal, tax is the most important source, typically accounting for 90 percent or more.

Shirras (1924) defined tax as a compulsory contribution to public authorities to meet the general expenses of the government, incurred for the public good and without reference to special benefits. The most fundamental takeaway is that tax is not a voluntary donation. It is a legal obligation imposed by the state. Failure to comply results in legal penalties, meaning the "compulsory" nature ensures the government has a predictable stream of revenue to function.

Taxes are important factors in determining the economic setting of any nation. They affect how, where, and when individuals, companies, and entrepreneurs choose to invest. In a country such as Nepal, which relies heavily on investments from both the local and international community for its development, tax policies can either encourage or discourage investment.

Changes in tax regulations can have a substantial impact on corporate investment strategies, particularly when they promote mergers and acquisitions. Tax policies that provide favorable treatment, such as deferred tax liabilities or reductions in capital gains taxes, make mergers and acquisitions transactions more attractive for firms pursuing growth through consolidation. Additionally, tax rules that allow for the deferral or exemption of taxes on reinvested earnings encourage companies to retain and reinvest profits domestically rather than distributing them as dividends. Such measures support long-term investments in capital projects and research and development, ultimately fostering sustained economic growth and enhancing competitive advantage (Hassett & Hubbard, 2002).

Terminologies used in taxation in Nepal

- **Assessment Year** -Year in which tax is calculated.
- **Custom Duty** -Tax on imported/ exported goods.
- **Direct Tax-** Tax paid directly by a person or company (e.g., income tax).
- **Excise Duty -** Tax on the production of specific goods like alcohol or tobacco.
- **Exemption -** Income or goods free from tax.
- **Income Tax -** Tax on income earned by individuals or businesses.
- **Income year -** The period in which income is earned and calculated for tax purposes.
- **Indirect Tax-** Tax collected through goods and services (e.g., VAT, excise duty).
- **IRD (Inland Revenue Department)-** Government body managing taxes in Nepal.
- **PAN** (Permanent Account Number) - Unique tax identification number in Nepal.
- **Penalty -** Fine for late payment or non-compliance.
- **Revenue-** Government income from taxes and other sources.
- **Special Industry -** An industry given special priority, facilities, or tax benefits by the government.
- **Tax -** Mandatory payment made to the government.
- **Tax Return -** Statement submitted to the tax office showing income and tax details.
- **Taxpayer -** Person or organization liable to pay tax.
- **TDS (Tax Deducted at Source)-** Tax deducted before payment is made.
- **VAT (Value Added Tax) -** Tax charged on the sale of goods and services.

- o **Windfall Gain** - Lottery, gift, prize, service tips, winning tips, and any gain received in the form of a windfall.

Objectives of the Study

The main objective of this article is to examine the impact of taxation on investment decisions in Nepal by analyzing its historical evolution, and identifying its current challenges. In addition, this article aims to evaluate the role of tax incentives in promoting investment in priority sectors such as information technology (IT), startups, manufacturing, and energy.

Methodology

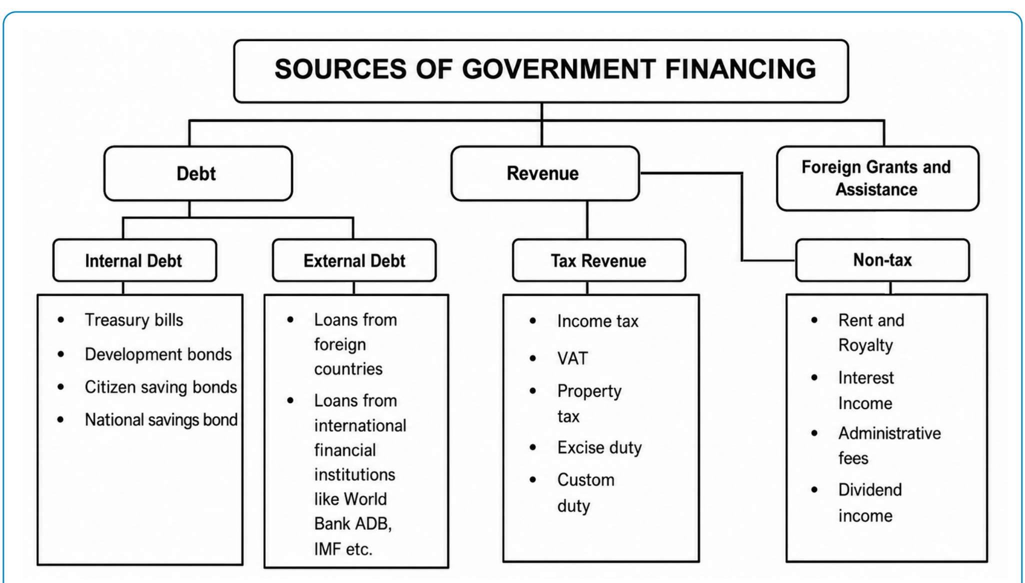
The study incorporates qualitative study based on literature review of secondary sources as mentioned in references. The sources are described and tabulated in relation with mainly tax history, challenges, investment section and government financing.

Sources of Government Financing

Government financing refers to the various methods and channels through which a state generates the necessary funds to meet its public expenditure requirements, ranging from infrastructure development to social welfare programs. These sources are broadly categorized into revenue receipts, such as taxes (direct and indirect) and non-tax revenues like fees, fines, and dividends from public enterprises, and capital receipts, which involve borrowing or the sale of assets. When domestic revenue is insufficient to cover the budget, governments often resort to public debt, sourcing loans from internal markets through bonds or seeking external assistance from international financial institutions and foreign governments. In some cases, states may also utilize deficit financing, which involves creating new money or drawing down cash balances, though this is typically managed carefully to mitigate inflationary risks (Kandel, 2011).

Figure 1

The Different Sources of Government Financing



In the context of Nepal, taxation is a powerful instrument that the government uses to navigate the delicate balance between revenue generation and economic stimulation. For a business operating in Nepal, tax laws — primarily governed by the Income Tax Act, 2058 (2002) and the annual Finance Act — are not just a compliance matter; they are a strategic factor that dictates where and how capital is deployed.

As of the 2082/83 (2025/26) Fiscal Year, Nepal's tax landscape has evolved to heavily incentivize specific sectors such as IT, energy, and manufacturing.

History of Taxation

The history of taxation is as old as that of organized civilization, even preceding the advent of coins. Taxes used to be payments made in the form of labor, produce, or animals to the ruling authority to fund the construction of public buildings (World History Encyclopedia, 2017).

History of Taxes (In-Kind Era)

The first record of organized taxation dates to approximately 3000 BCE.

Ancient Egypt. The pharaoh would tour his realm once every two years and assess the value of cattle and produce, collecting taxes from crop yields. The revenue collected helped finance major construction projects such as the building of the pyramids.

Mesopotamia (Sumer). Taxes were recorded on clay tablets as a "burden" at around 2500 BCE. Those who could not pay in kind were required to fulfill their tax obligations through labor (corvée), which included the construction of canals, service at religious ceremonies in temples, or military service.

Ancient Greece and Rome. Liturgies were used to pay for festivals, naval ships, or public services. Rome adopted taxes on land, customs duties, and a 1 percent sales tax under Julius Caesar.

The Medieval Period

During the Middle Ages, taxation was primarily feudal. Peasants worked for local lords and gave them a share of their harvest in exchange for protection.

The Tithe. This referred to the mandatory levy of 10 percent of one's income or production to the Church.

The Magna Carta (1215). A defining moment in tax history, King John of England was compelled to accept that taxes "scutages" could not be levied without the consent of the kingdom.

The Modern Era

The 18th and 19th centuries saw the birth of the systems we recognize today:

No Taxation Without Representation. This slogan became a catalyst for the American Revolution, following British-imposed taxes such as the Stamp Act.

The First Income Tax. Introduced in Great Britain in 1799 by William Pitt the Younger to finance the Napoleonic Wars. It was intended to be temporary, but it set the precedent for modern revenue collection.

World Wars. The 20th century world wars transformed income tax from an "upper-class" tax into a "mass" tax to fund massive military expenditures.

History in Nepal

While the concept of state revenue in Nepal dates back to ancient times, the modern framework is relatively recent:

Ancient/Medieval Era. Revenues were primarily collected through land taxes and tariffs on trade with Tibet and India.

1951 (Post-Democracy). The first consolidated budget was implemented.

1959/60. The first elected government introduced the Business Profit and Salaries Tax

Act, marking the beginning of formal income taxation in Nepal.

2002 (2058 BS). The current Income Tax Act, 2058, was enacted, modernizing the system and replacing the older 1974 Act.

Benefits of Tax Paying

Paying taxes in Nepal is often viewed through the lens of compliance, but for 2026, the government has integrated several direct financial incentives and legal advantages that reward taxpayers (Government of Nepal, 2059).

Direct Savings and Deductions (Individuals)

For salaried and self-employed individuals, tax compliance allows for a lower effective tax rate through several legally approved deductions:

Retirement Contributions. Contributions to the Social Security Fund (SSF), Employee Provident Fund (EPF), or Citizen Investment Trust (CIT) can be deducted up to the lower of one-third of income or Rs. 500,000.

Insurance Rebates. Up to Rs. 40,000 for life insurance premiums and Rs. 20,000 for health insurance can be subtracted from taxable income.

Remote Area Allowances. For those working in designated "remote" or "underdeveloped" districts, taxpayers are eligible for an additional deduction ranging from Rs. 10,000 to Rs. 50,000, depending on the category of the region.

Female Taxpayer Rebate. Women who file taxes as individuals (not as a couple) receive a 10 percent rebate on their total calculated income tax.

High-Growth Sector Incentives (IT and Startups)

The 2025/26 Finance Act significantly rewards the tech and startup ecosystem.

IT Export Rebate. IT companies earning foreign currency through software or service exports enjoy a 75 percent rebate on their income tax.

Startup Tax Holiday. Newly registered, innovation-driven startups with an annual turnover under Rs. 10 crore can receive a 100 percent income tax exemption for the first five years.

Simplified Freelancer Tax. For individuals exporting IT services, the tax is often a flat 1 percent to 5 percent final withholding if the income is received through formal banking channels.

The "Financial Passport" (Practical Benefits)

In Nepal, a Tax Clearance Certificate (TCC) acts as a critical document for several life milestones.

Bank Loans. A significant personal or business loan cannot be secured without tax returns. Banks use IRD (Inland Revenue Department) filings as the ultimate proof of income.

Visa Applications. Embassies in Nepal (especially those of the US, UK, and Australia) prioritize applicants who can demonstrate a consistent tax history as evidence of financial stability and ties to Nepal.

Government Tenders. Under relevant regulations, contractors and consultants are legally prohibited from bidding on government projects unless they possess an up-to-date tax clearance.

Social Security Benefits

Taxpayers who contribute to the Social Security Fund (SSF) gain access to a safety net that traditional savings cannot match.

Health and Maternity. Coverage for medical treatment (up to Rs. 100,000 per year) and maternity benefits after a qualifying period of contribution.

Pension for Life. Unlike a one-time gratuity, the SSF provides a monthly pension after the age of 60, adjusted for inflation every three years.

Accident Insurance. Immediate coverage for workplace injuries, including disability compensation and dependent family support in the event of death.

New Digital Rewards

To promote the "Digital Nepal" framework, the government offers a 10% VAT refund to consumers who pay for goods or services using electronic means such as digital wallets like eSewa or Khalti, or QR codes at participating VAT-registered merchants.

Table 1

Tax vs. No Tax

Feature	Compliant Taxpayer	Non-Compliant
Loans/Credit	High eligibility, lower interest rates	Very difficult to secure
Travel	Smoother visa approvals	Higher risk of visa rejection
Business	Can bid for the government and large contracts	Restricted to informal markets
Refunds	Can claim overpaid taxes	Money is lost to the state

Challenges in Tax Paying

Taxpayers often struggle with complex tax laws and procedures that are difficult to interpret without professional assistance. The intricacy of these rules creates confusion and discourages compliance, especially among individuals and small businesses that lack access to expert guidance. This challenge is compounded by a lack of awareness about tax rules, as many citizens are not adequately informed about their obligations, exemptions, or filing processes.

Another major concern is the burden of high tax rates, which can feel excessive and demotivating for taxpayers. Combined with the significant time spent on paperwork, the process becomes not only financially demanding but also administratively exhausting. Lengthy forms, repetitive documentation, and bureaucratic hurdles make tax filing a stressful experience for many.

The situation is further worsened by corruption and unfair practices within the system, which erode confidence in fair treatment. Even when taxpayers attempt to comply, they often face poor online systems and technical issues that delay submissions or cause errors. These inefficiencies highlight the need for stronger digital infrastructure to support smooth tax administration.

Underlying all these challenges is a lack of trust in the government's use of tax money. Many citizens feel uncertain whether their contributions are being utilized effectively for public welfare. This skepticism, combined with the fear of penalties for mistakes or late payments, creates a climate of anxiety and reluctance around taxation. Together, these factors illustrate why tax compliance remains a daunting task for many individuals and organizations.

Types of Tax

Direct Tax

Tax paid directly by a person or organization to the government, such as income tax, house tax, vehicle tax, rent tax, etc.

Indirect Tax

Indirect tax is a tax that is charged to one person, who then shifts its burden to another person, such as through VAT, sales tax, excise duty, and customs duty.

Tax Policy and Investment Decisions

The term “tax policy” can be defined as the government's stance on taxation in terms of tax rates, incentives, exemptions, and regulations. Investment decisions refer to the allocation of resources into tangible or intangible assets, such as property or stocks, which generate income for the investor.

Tax policies influence investment decisions through changes in the return, risk, and cost of investments. The following are the main factors through which tax policy affects investments (Bhattarai et al., 2071).

Corporate Income Tax (CIT) and the “Hurdle Rate”

The standard CIT rate in Nepal is 25%. For businesses, this rate acts as a direct reduction in the Net Present Value of an investment.

The Impact. When a firm considers a new project, it calculates a “Hurdle Rate” (the minimum acceptable return). A 25 percent tax means the project must be significantly more profitable to break even compared to a tax-exempt environment.

Variation by Sector. Nepal uses differential rates to drive investment toward specific areas. For example, Banks and Financial Institutions (BFIs) are taxed at 30 percent, while “Special Industries” (manufacturing) and exporters often enjoy a reduced rate of 20 percent.

Strategic Incentives: The IT and Startup “Boom”

Recent Finance Acts have introduced aggressive tax holidays to position Nepal as a digital hub.

IT Export Incentives. To encourage investment in software development and BPO, the government offers a 75 percent tax exemption on income earned from the export of IT services. This effectively brings the tax rate down from 25 percent to 6.25 percent, making Nepal a highly competitive location for digital investment.

Startup Holidays. New startups utilizing innovative technology with a turnover of up to Rs. 100 million (10 crore) are granted a 100 percent income tax exemption for the first five years. This drastically reduces the initial capital risk for entrepreneurs.

Depreciation and the “Time Value” of Money

Nepal follows a pool-based depreciation system (Categories A to E). The way these pools are structured influences how quickly a business can recover its investment cost.

Accelerated Depreciation. Special industries and certain infrastructure projects are often allowed to claim an additional one-third of the normal depreciation rate.

The Decision. If a manufacturing plant can write off its machinery faster, it improves immediate cash flow, allowing the business to reinvest those funds into a second production line sooner.

Dividend Taxation and Repatriation

For investors, especially foreign ones (FDI), the “exit” tax is as important as the operational tax.

Withholding Tax. Nepal levies a 5 percent final withholding tax on dividends.

Reinvestment Incentive. The 2082/83 budget provides a significant incentive for growth: if an IT company capitalizes its accumulated earnings to enhance capacity, the 5 percent dividend tax is fully exempted. This encourages businesses to retain their profits within Nepal to scale up rather than withdrawing them.

Indirect Taxes: The VAT and Customs Factor

While CIT affects profits, Value Added Tax (VAT) and customs duties affect the initial cost of investment.

Exemptions. The government often waives VAT and provides customs concessions on the import of machinery for "priority sectors" such as green hydrogen or electric vehicle (EV) charging stations.

The Result. This lowers the initial outlay (the cost of starting a project), making capital-intensive industries more viable for local investors.

Table 2

Nepal Tax Impact on Investment

Policy Areas	Specific Provision (FY 2082/83)	Business Decision Impact
Standard CIT	25%	General benchmark for project viability.
IT Export	75% Tax Rebate	High incentive for BPOs and Software firms.
Startups	5-year Tax Holiday	Encourages risk-taking and innovation.
Manufacturing	20% CIT (Special Industry)	Encourages local production over trading.
Green Energy	Excise/Customs Exemptions	Lowers the entry barrier for EV and Hydrogen.

Conclusion

In Nepal, taxation is no longer a "one-size-fits-all" burden. The article found that taxation has a considerable influence on investment decisions in Nepal. Even though taxation has improved in many ways over the years, factors such as complexity, inconsistent policies, and poor implementation remain issues that hinder investment. Tax incentives can assist in attracting investment in critical areas, including IT, entrepreneurship, manufacturing, and energy, among others.

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