# Expressly disallowed expenses for deduction under the income tax acts in Nepal, India and United Kingdom

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## Abstract

*This paper aims to analyse the provisions of expressly disallowed expenses for deduction while computing the taxable income under the income tax acts. The study uses a qualitative approach of doctrinal legal research to explain the state of affairs of past and present provisions. Consequently, it employs the primary and secondary sources of data and information from the enacted income tax Acts, Rules, journals, reports, bulletins, precedence, books, dictionaries, encyclopedias, indexes, etc. The study found the expenses that are expressly disallowed for deduction are explicit provisions in the ITA, 2002 followed by the ITA, 1974 however, the former two Acts (i.e., ITA 1960 and ITA 1962) lack the provisions of such non-deductible expenses. The result showed the latter two Acts (i.e., ITA 1974 and ITA 2002) were found adequate in the context of Nepal and they are comparatively equal to the Indian and the UK's income tax acts. It is usual today but there are some places for improvement in this subject considering the society, culture, economy and political system in Nepal. The paper provides an explicit result of the disallowed expenses of the personal, domestic and capital nature those which are not related to earning or receiving the income. Thus, the study furnishes new knowledge in the literature on income tax in Nepal.*

***Keywords**: Disallowable, allowable, income tax, fines and penalties, capital expenses, personal and domestic expenses, large taxpayers.*

## Introduction

A tax is a compulsory levy that governments or their agencies impose on taxable income of the persons (individuals and entities) to raise the required treasury which they require to run the affairs of the government, to achieve other macro-economic objectives and fiscal policies of the government. Income taxation is a complex subject not only in its justice, equity and fairness it is equally complicated for the calculation of tax liability. It includes many provisions and requires several steps to determine the exact amounts of its tax liability. If we decomposed the total items of expenses they may be under several types and nature.

The income taxes always include two types of provisions for expenses (e.g., the first is what to allow and the second is what not to allow for deduction). In most cases, these two types of provisions can create confusion because one can override another provision/s while we use the provisions of the income tax system. Normally, in theory, the provisions of overriding should be used first and then should decide the allowability of the expenses. In the tax matter, if any expenditure is not allowable due to any provision laid down in the Act then the expense/cost is considered taxable. In the case of allowable, there are two types of provisions (i.e., general and specific) in Nepal. The first requires three basic rules of thumb (e.g., (i) expenses incurred by the person, (ii) expenses incurred for the year and (iii) expenses incurred for receiving or earning the income). The provision of specific deductions requires additional rule/s each including the three rules of thumb. The expenses of the revenue nature deal with the perfectly deductible if the expenses complete the basic norms of the basic rules of thumb.

The Income Tax Act 2002 (ITA 2002) expressly disallows some expenses for deduction while computing the taxable income of a person. The expenses represent the amount spent by persons for different purposes in the course of business and investment, which they claim to deduct from their incomes to obtain the taxable income. However, in some cases, provisions of the income tax do not permit to deduct of expenses expressing that "notwithstanding anything contained in this Act, to calculate a person's income for an income year, from any business, employment and investment, no deduction is allowed" (p. 32). Thus, expenses that are personal or domestic or of capital nature or distribution by the entities or foreign income tax are always expressly disallowed for deduction while computing the taxable income.

Thus, in this paper, we discuss the expressly disallowed expenses for deduction while calculating the taxable income–quoted in the sections or subsections–in the income tax Acts since their application in the income tax regime in Nepal.

**Problems**

Nepal introduced periodic planning in 1956, i.e., six and half-decades ago. However, also to date, it has stood as the least developed country not only in the South Asian region but also nearly in around the world. According to the World Bank (2020), in 2018, the Gini Index (GI) of Nepal is 39.50% while it was 32.80% in 2010. It shows the disparity between rich and poor is growing in later years. The GI is a yardstick to measure the distribution of income (or, in some cases, consumption expenditure). The lower the percentage of the GI represents the lower the inequality (0 represents that perfect equality, and 100 perfect inequality) in the society.

The ITA 2002 of Nepal provides the duties and power to both i.e., taxpayers and tax authorities in the payment and collection of tax revenue. It suggests a fully self-assessment system of income taxation to the taxpayers but the power of the examination to the tax authorities. Although, such facilities were found misused by both parties. In this connection, the annual report of the Inland Revenue Department (IRD) of Nepal shows that the case of mismatch and reassessment in the return file of income tax are continuously growing in later years (IRD, 2078). These also may be occurred through the intention of hiding the fact or lack of knowledge of taxpayers or tax authorities while calculating the taxable income.

The main objective of expenses that are expressly disallowed for deduction while calculating the taxable income is the control of the non-related expenses. The provisions of expenses disallowed for deduction increase the taxable income and contract the deduction (i.e., it may be called contraction of tax credit too) from income. In the case of Nepal, the subject is under an unstudied yet to date. Thus, this article tries to trace and add the literature on the provisions of the expressly disallowed expenses for deduction while computing the taxable income in Nepal.

**Purpose**

The major objective of the study is to assess the provisions of the expressly disallowed expenses for deduction while computing the taxable income under the income tax Acts and the secondary objectives are as follows:

- To assess the expressly disallowed expenses while computing the taxable income in Nepal.
- To compare the disallowed expenses for deduction while computing taxable income in India and the United Kingdom (UK)).

**Scope and limitations**

Income tax is a recent innovation in the tax system all over the world. It is a more controversial but comparatively less studied subject. Few scholars know the income tax but no one can be perfect in the tax system. Consequently, this study is a cornerstone in this matter. Thus, all those scholars such as professors, chartered accountants, auditors, tax officials, social advocates, lawyers, etc. will be benefited from this study. However, this study is limited to the provisions of four tax laws in Nepal. As well as a limited comparison such as India and UK. The study covers the duration of 60 years from 1960 to 2020 only. The availability of resources, time and cost for the resource were not ignoble in these circumstances.

## Literature Survey

The literature survey of this study aims to synthesize the previous studies on this topic. However, by the nature, scope and subject of the literature, there are very few pieces of literature on this topic. Thus, the study was conducted based on the underlying literature.

Hinojosa (2021) and Uzialko (2021) viewed various types of accounting such as (a) financial accounting, (b) managerial accounting, (c) cost accounting, (d) auditing, (e) tax accounting, (f) accounting information systems, (g) forensic accounting, (h) public accounting and (i) governmental accounting. Among the types of accounting, tax accounting is applied in the matter of taxation.

K.C. (2007) argued that based on legal approach and purpose, the tax accounting concerns a single-entity approach to determine the income tax liability. It covers six significant objectives (a) to establish tax liability, (b) to protect the state revenue, (c) to maintain a neutral effect on the economy, (d) to provide equity and (e) to avoid double taxation, and (f) to enable non-fiscal objectives such as incentives or disincentives. Similarly, the tax accounting alarms the valuation principles such as realization, prudence, annual liability (loss carryovers, depreciation, deferrals), recognition of foreign tax, profits smoothing, etc. Thus, the principles of tax accounting are closely related to expressly disallowed deduction while computing the taxable income. The reasons behind the non-deductible expenses belong to the principles described below.

The deductible expenses are those which reduce the tax liabilities while non-deductible expenses are those which do not minimize the tax amount to be paid. In income taxation, certain expenses are always deductible, which directly concerns the earning or receiving the income by the person for the year, but the expenses of personal or domestic nature, capital nature and expenses of the previous or consecutive years are not never deductible. In other words, the costs or expenses to be subtracted from the earned income, either should fulfil the certain norms of the deduction of matching principle or should be statutory as expressly provided in the law.

Garcia (2008) explained the theory of causality between income and its related expense. The connection of the expenses with income at least these three criteria (e.g., the expense incurred for receiving or earning the income, the expense incurred during the year and the expenses incurred by the person) is to be fulfilled.

HM Revenue and Customs (2013) of the United Kingdom (UK) highlighted various types of deductible and non-deductible expenses and explicitly express disallowed deduction in respect of the calculation of the income tax in the UK. In the case of India, Singhania (2013) discussed the provision of expressly disallowed expenses for India as provided by Indian ITA, 1961. Similarly, in the case of Nepal, K.C. (2016) concluded the prevailing law permits to deduct real expenses but does not permit the expenses or costs of non-business, personal and capital nature.

The review of the literature revealed that it is scarce in the literature of expressly disallowed deduction. Thus, considering the fact, we chose to add the literature on this subject matter.

## Research Methodology

Vibhute and Aynalem (2009) defined legal research as a "Systematic finding law on a particular point and making advancement in the science of law" (p. 2). The study employs a qualitative approach for doctrinal legal research to explain the state of affairs of past and present provisions (Singh, Bajpai, & Pandey, 2018) using the different sources of information.

In doctrinal legal research, the concept of sources of data and information differs substantially. According to the approach, the analysis of law provisions consists of the primary data using the research papers published in legal periodicals/ journals, reports, theses and conference papers.

Similarly, the secondary information (data) includes textbooks, treatises, commentaries on statutes, abstracts, bibliographies, dictionaries, encyclopedias, indexes, reviews, and thesauri and directories, subject guides and Union lists under tertiary. To analyze the result, we describe the legal element using precedence and compare them with the provisions of other laws providing evidence of reasoning (K.C., 2016).

The study compiled the data of the non-deductible expenses from different acts and tabulated them into various tables to analyze and systematically compare them considering the different income tax regimes in Nepal. Similarly, the non-deductible expenses data of India was obtained from the Income Tax Act, 1961 of India.

The study of the non-deductible expenses covers the sole income tax system of the four generations in Nepal for a period of 60 years from 1960 to 2020.

## Results

This section presents that the provisions expressly disallowed deduction prescribed in the four income tax Acts of Nepal (i.e., ITA, 2002 (2058); Income Tax Act, 1974 (ITA, 1974); Income Tax Act, 1962 (ITA, 1962) and Business Profit and Salary Tax Act, 1960 (BPSTA, 1960)).

### Disallowed expenses in the Nepalese Acts

In the analysis, the ITA 2002 is the fourth generation ITA and the third is the ITA, 1974. These only two acts mention the provision of expressly non-deductible but there are no provisions of expressly disallowed expenses in the earlier income tax Acts (i.e., ITA, 1960 and 1962)  Thus, the study excludes those two Acts from the analysis.

#### *Expenses of personal and domestic nature*

This category of disallowed deduction includes especially two types of expenses: (i) personal nature and (ii) domestic nature which do not incur under the normal business or investment income.

Table 1

*Expenses of personal and domestic nature*

| Descriptions | ITAs | |
|---|---|---|
| | 2002 | 1974 |
| 1. Expenses of personal and domestic nature | ● | ● |
| (a) Personal expenses incurred by an individual | ● | ● |
| (i) The interest of the personal loan | ● | |
| (ii) Expenses incurred on behalf of an individual | ● | ● |
| • Expenses incurred on individual commuting | ● | |
| • Clothing expenses of outside work | ● | |
| • Education expenses of scholarly qualified degree | ● | |
| (iii) Costs incurred by another person in respect of an individual | ● | |
| • If the payment is included in calculating individual income | ● | |
| • If an individual makes a return payment of an equal market value | ● | |
| • If the payments are so small and impractical to keep accounts | ● | |

*Source: ITA (2017), (2019), (2031) and (2058)*

Table 1 revealed that disallowed expenses for deduction are directly or indirectly connected with the domestic and personal nature. However, they are more specific in the ITA 2002 than the ITA 1974. Thus, the expenses are expressly disallowed to the extent to which they are of a private or domestic nature.

***Amount of income taxes, fines and penalties***

In the income taxation, income tax, fines on income tax and income-related other expenses such as the cost of suing against the income tax (i.e., lawyer or consultant charge or brokerage, court fees, etc.). Similarly, fines and penalties paid to the central or local government are no allowable deduction.

Table 2

*Income tax, income tax-related expenses, fines and penalties*

| Descriptions | ITAs | |
|---|---|---|
| | 2002 | 1974 |
| 2. The amounts of: | | |
| (i) income tax and expenses of income tax-related such as sue against income tax, lawyer expenses against sue, etc. | ● | ● |
| (ii) fines such as fines related to negligence and | ● | ● |
| (iii) penalties | ● | ● |

*Source: ITA (2017), (2019), (2031) and (2058)*

Table 2 portrayed that the income tax or foreign tax; fines and penalties imposed under the Nepalese or ordered by the courts are expressly disallowed for the deduction. Similarly, borrowing expenses related to a loan that was taken out to pay a tax liability and fees for advice on the operation of tax law against the sue of tax liability are also disallowed for the deduction. Fines or penalties also fall under the disallowed where they include the following amounts:

- Paid because of a conviction for a crime or after a plea of guilty or no contest in a criminal proceeding.
- Paid as a penalty imposed by central or local law in a civil action.
- Paid in settlement of the actual or possible liability for a fine or penalty, whether civil or criminal.
- Forfeited as collateral posted for a proceeding that could result in a fine or penalty.

However, a fine or penalty does not include any of the following:

- Legal fees and related expenses to defend in a prosecution or civil action for a violation of the law imposing the fine or civil penalty.
- Court costs or stenographic and printing charges.

***Expenses related to exempt income and final withholding related income***

According to the matching principle of the tax accounting, an excluded income should be either exempted or final withholding. Thus, expenses of excluded income are not deducted from taxable income.

Table 3

*Expenses related to exempt income and final withholding related income*

| Descriptions | ITAs | |
|---|---|---|
| | 2002 | 1974 |
| 3. The cost incurred while earning tax-exempted income and final tax deduction amounts | | |
| (i) The cost incurred while earning the tax-exempted income | ● | ● |
| (ii) The cost incurred while earning final withholding payments | ● | ● |

*Source: ITA (2017), (2019), (2031) and (2058)*

Table 3 communicated that where an Organisation has non-assessable income, the expenses related to earning such incomes are expressly disallowed for deduction  According to the ITAs of Nepal, they disallow expenses for deduction the expenditure or loss to the extent to which they are incurred in the production of income which is exempt or final withholding. It is a treatment of the matching principle of tax accounting.

***Expenses of capital nature and distribution of profit by an entity***

The expense of capital nature contributes to earning income or receiving the income for more than a year. Thus, the whole amount deduction in the purchased year could not be justifiable as the matching principles of tax accounting. Similarly, an entity is a person. Consequently, fundamentally, the investor should take any profit after the deduction of income tax. According to the principles, the ITAs have provisioned the following expenses for non-deductible while calculating the taxable income.

Table 4

*Distribution of profits and expenses of a capital nature*

| Descriptions | ITAs | |
|---|---|---|
| | 2002 | 1974 |
| 4. Any distribution of profit by an entity | ● | ● |
| 5. Other expenses | ● | |
| (i) Cost of capital nature | ● | ● |
| (ii) Any reserve and provision | ● | ● |
| (iii) Foreign income tax | ● | |

*Source: ITA (2017), (2019), (2031) and (2058)*

Table 4 disclosed the expressly disallowed expenses while calculating the taxable income according to the principles of expenses for more than a year (i.e., capital nature), the expenses which should be made after payment of income tax (i.e., distribution of profit) and finally to avoid the double taxable in these concepts.

***Special rules for large taxpayers***

The provisions of ITAs prevent the taxpayer's intention of the expense increment in an illegal way. To reduce the undue payment or to break the fraud entry on the tax accounting there are some special rules and provisions as given below:

Table 5

*Special rule of disallowed expenses*

| Descriptions | ITAs | |
|---|---|---|
| | 2002 | 1974 |
| 6. Special rules for deductions denied for large taxpayers or whose income is Rs. 2,000,000 in any income year the payment of cash more than Rs. 50,000 at once the time is the non-deductible expense. | ● | |

*Source: ITA (2017), (2019), (2031) and (2058)*

The stated rules apply only to the large taxpayers who make an annual turnover of rupees two million or more they are not able to cash payments over rupees 50,000 at one time. The cash payment is defined; as the payment other than through a bank or financial institution by way of a letter of credit, check, draft, money order, money transfer (hundi) or any other form. However, it is an allowable deduction from income from business or investment if cash payment is made to the following persons:

- paid to the Government of Nepal, a constitutional body, a corporation owned by the Government of Nepal, or a bank or financial institution.
- paid to a farmer or a producer of primary agriculture products, also if the farmer himself primarily processes the product.
- paid to a retirement contribution or a retirement payment paid to a beneficiary.
- paid in an area where the banking facilities are not available within a radius of 10 kilometres.
- paid on the off-day or on a day when banking services are closed.
- payment made into a bank account of the recipient.

***Other disallowed expenses in Nepal***

According to ITAs, Rules and precedence of the court, some expenses are not allowed for deduction while calculating the taxable income. Such major expenses are as given below:

Table 6

*Other disallowed expenses*

| Descriptions | ITAs | |
|---|---|---|
| | 2002 | 1974 |
| 7. Remuneration, interest, commission, rent, or bonus paid to partners of taxpayers or members but a reasonable amount paid to the chief executive is deductible. | | ● |
| 8. Payment of additional commission or discount other than regular. | | ● |
| 9. Rent on the house and compound or any other property belonging to the taxpayer himself. | ● | ● |
| 10. Reserve fund or similar other funds allocated from profit | ● | ● |
| 11. Expenses not incurred for earning or receiving the income. | ● | ● |

*Source: ITA (2017), (2019), (2031) and (2058)*

The ITAs of Nepal restrict the amount of remuneration from any name such as interest, bonus, additional commission, discount, rent of house and property belonging to the taxpayer himself, reserve fund from income and those expenses which are not related to earning or receiving the income are the expressly non-deductible items while computing the taxable income.

***Expressly disallowed expenses in the United Kingdom (UK) and India***

The neighbouring country India is culturally and socially structurally similar to Nepal. Thus, in this regard, we try to compare the provision of expenses disallowed for the deduction of the income tax Act with that country. Similarly, the sources of the Indian tax law concern the UK because great Britain ruled over India for 100 years. Thus, directly and indirectly, the Indian tax law is influenced by the Great Britain Law. Singhania (2013) stated that the Indian ITA, 1961 disallows the following expenses for deduction from the claimed income of the business or profession.

Table 7

*Provisions of expressly disallowed expenses in the UK and India*

| United Kingdom (UK) | India |
|---|---|
| (1) Income taxes, fines and penalties<br>• Costs of the settling tax disputes and fines for breaking the law,<br>• Repayment of the loans or overdrafts or finance arrangements, | (1) Income taxes, fines and penalties<br>• Payment of income tax and its fine;<br>• Payment of wealth tax; |
| (2) Capital cost<br>• Legal costs relating to the buying of property and large equipment; | (2) Unapproved gratuity<br>• Provision for unapproved gratuity; |
| (3) Capital and revenue loss<br>• Depreciation of equipment, cars, etc., losses on sales of assets (minus any profits on both types of sales: capital and revenue); | (3) Without an effective arrangement<br>• Establishment of provident fund for the benefit of employees without effective arrangement; |
| (4) Personal and non-business expenses<br>• Entertaining clients, suppliers and customers; hospitality at events,<br>• Repairs of non-business parts of premises or equipment; costs of improving or altering premises and equipment, and<br>• Non-business motoring costs (private use proportions); fines; costs of buying vehicles; travel costs between home and business; other meals,<br>• Non-business or private use proportion of expenses; new phone, fax, computer hardware or other equipment costs,<br>• Payments for non-business work,<br>• Costs of any non-business part of the premises; costs of buying business premises, | (4) Unreasonable payment<br>• The excess or unreasonable payment made by assessors to a related person;<br>(5) Payment made without withholding<br>• Payment made without withholding on interest, royalty, fees for technical services, etc., paid or payable to a non-resident or outside India;<br>• The amount of interest, commission or brokerage, fees for professional services or fees for technical services paid or payable to any resident person without withholding;<br>• Payment of salaries and perquisites without withholding outside India or without withholding paid to non-resident persons;<br>(6) Cash payments more than Rs. 20,000 other than the account payee cheque or draft at one chance; |
| (5) Payments to clubs, charities, political parties, etc., non-business part of any expenses; the cost of ordinary clothing, | (7) Provision of any fund; |
| (6) Debts not included in turnover; debts relating to fixed assets; general bad debts | (8) The following sums not paid before the due date of filing the return of income |

| United Kingdom (UK) | India |
|---|---|
| (7) Recoverable costs,<br>(8) Own wages and drawings, pension payments or payments for non-business work. | • Any sum is payable by way of tax, duty, cess, fee, etc.<br>• Bonus or commission to employees;<br>• Interest on loans or borrowing from any public financial institutions, etc.<br>• Interest on any loans and advances from a scheduled bank;<br>• Leave encashment;<br>• Contribution to any provident fund, superannuation fund, gratuity fund, etc. |

*Source: Income Tax Act (1999), Singhania (2013) and Report HM Revenue & Customs (2013)*

The discussion of this section revealed that the provision of the expressly disallowed deduction from the income of Nepal is moderately similar to other countries.

## Discussion

This section explicitly discusses the provisions of the income tax Acts from the very beginning. It also discusses the provisions of other countries which are the sourced laws for the Nepalese income taxation laws.

The former two Acts (i.e., BPSTA, 1960 and ITA, 1962) of Nepal did not make the provisions of expenses that are expressly disallowed for deduction from the business or investment income. However, there existed a fundamental principle of deduction of actual or real expenses. Due to various reasons, (i.e., complication, unclear, vague, undue influence, and unlimited power of tax officers) the government of Nepal changed the first Act after two years, and the later after twelve years enacted the new income tax Act 1974.

In 1974, the government of Nepal (contemporary His Majesty Government of Nepal (HMG/N)) enacted the new version of the Income Tax Act, 1974. Contemporarily, it was adequate to impose the income tax in Nepal. It was amended eight times and lasted up to 2002. The main blame for this income tax was the willful power of the tax officer that the provision laid down in section 28 of that Act "Power to Direct Submission of Particulars".Similarly, in Nepal, the provisions of income tax were also included in different Acts. It was necessary to gather and compile it into one. Thus, the government of Nepal (contemporary HMG/N) enacted the ITA 2002.

The prevailing ITA 2002 is one of the most sophisticated acts of Nepal among the enacted acts of Nepal to date. It covers most of the current economic events related to income and it is nearly equal to other countries' ITAs.

## Conclusion

The law of any country consists of its society, culture, economic, and political value to some extent. The income tax laws of Nepal are not an exception to those values. To my knowledge, they have been coming with the shift in society, culture, economic transformation and political situation significantly.

The first and second income tax laws did not make any special provisions about the expressly disallowed deductions. But, the third income tax act, of 1974 made clear provisions about it and the prevailing income tax Act improved and added some new provisions for the disallowed deduction which reduces the evasion of the income tax to some extent.

The overall observation of the income tax regime showed that the prevailing income tax Act of Nepal found moderate (neither it is so good nor bad) compared to the income tax law of the neighbouring country

India and the European Country UK.

A sound framework and a workable system can indeed shape the economy in our country potentially. Thus, the government should continue its improvement to the change in culture, society, political system and economy. The case of its effects on economic growth and development requires further study to conclude the subject.

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