AMCHAM POSITION PAPER

Top 10 Issues in the Mongolian Tax Environment

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BACKGROUND

To effectively attract foreign investment, it is essential to establish a favorable tax environment. Given that a significant portion of budget revenue is derived from the export of mining products and raw materials, it becomes necessary to develop a tax framework that attracts investors, promotes manufacturing, export, and the processing of value-added goods. Consequently, it is imperative to assess the relevant tax laws, rules, and regulations that negatively influence the investment and manufacturing industries. The objective is to lessen the tax burden on business owners and promote coherence among tax laws and regulations. It is evident that private sector enterprises, which serve as the foundation of Mongolia's economy, encounter several challenges associated with executing tax legislation. The top ten challenges include:

1. License transfer tax (LTT)
2. Mining royalties
3. Withholding tax (20%)
4. Value-added tax (VAT)
5. Reverse charge VAT (RCVAT)
6. Tax dispute mechanisms
7. Holding structure (foreign and domestic)
8. Progressive income tax
9. Stabilization of the tax environment
10. Tax incentives

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ONE. LICENSE TRANSFER TAX

License transfer tax blocks mining investments at the entry stage:

- The LTT calculation methodology taxes a project's net present value (NPV), which erodes the internal rate of return (IRR), rendering financial models unviable and unprofitable.

- Under the current methodology, taxable income from the sale of rights significantly deviates from the actual transaction value. For mineral licenses, tax is imposed based on future cash flow projections. This means tax is collected upfront for a project's future cash flow, which eliminates the expected return on investment for an investor and makes it impossible to invest.

- According to Article 30.2 of the Corporate Income Tax (CIT) Law, the taxable person for an indirect transfer is the rights holding entity, e.g., income earned by the ultimate holder for the disposal of shares in the rights-holding entity is deemed to be income earned by the rights-holding entity (e.g., the rights-holding entity bears the tax cost on behalf of its direct and indirect shareholders). The LTT contradicts the fundamental regulation stated in Article 9.3 of the Company Law, which states, "Shareholders shall not be liable for the obligations of the company and shall only be liable to the extent of their shares in the company." A shareholder of a Mongolian entity is a separate legal entity and should only be responsible for paying its own taxes, not for the tax liabilities arising from the sale of shares by direct or indirect shareholders. This severely undermines the principle that a company is liable only to the extent of its contributed capital and that its assets are separate from those of its shareholders.

- LTT results in double taxation on a single mergers and acquisitions transaction, with taxes on the sale of shares and LTT. This contradicts international best practices. LTT has been a significant barrier to new investment for many years.

- A single transaction is taxed twice as income from the sale of shares and income from the sale of rights granted by a government agency. The issue of double taxation has been addressed for resident taxpayers, with the applicable tax imposed on the highest income only under Article 30.7 of the Corporate Income Tax Law. However, this exemption does not apply to non-resident entities, resulting in double taxation.

Related legal provisions

- Articles 4.1.12 and 30 of the Corporate Income Tax Law
- Article 6.1.48 of the General Law on Taxation
- Article 9.3 of the Company Law
- Article 3.1.6 of the Law on Combating Money Laundering and the Financing of Terrorism
- Ministry of Finance Decree No. 302, Annex 1, issued in 2019, on the methodology to determine the value of minerals, radioactive minerals, oil exploration licenses, and mining licenses and assess taxable income

Recommendations:

To align with international standards and attract investors, abolishing the license transfer tax is highly recommended. LTT has created significant obstacles to attracting foreign investment. It is impossible to attract foreign investment and create a favorable investment environment until the LTT is abolished.
Furthermore, it is critical to establish a uniform approach to the definitions of ultimate and beneficial owners recognized by the tax authority and state registration office. This will help end discrepancies in the interpretation of circumstances surrounding changes in ultimate ownership that result in inconsistent tax applications.

TWO. MINING ROYALTY

Mining royalties are the largest contributor to an unreasonably high effective tax rate (ETR):

- Although Mongolia's CIT (25 percent) is comparable to other countries, the primary tax for mining companies is royalty on offtake, calculated based on the sales value of extracted minerals. The two-tiered mining royalty (standard flat rate and surtax) plus special royalty is the highest compared to similar countries.

- The ETR in Mongolia is around 60 percent in the exploration and feasibility study phases, with the ETR ranging from 70–80 percent, significantly higher than the international average of 40–50 percent. This deters investors and is causing the risk of prolonged stagnation in the sector's development.

- The ideal tax rate inversely correlates with the country's risk level. Mongolia is perceived as a high-risk environment for investors. Its ETR is notably less competitive compared to those of low-risk nations, such as the United States (23 percent for copper projects in New Mexico), Canada (39 percent for copper and gold projects in Ontario), and Australia (31 percent for copper projects in Western Australia).

- Calculating royalty based on sales value/ benchmark price puts too much pressure on investors. A benchmark price set by the exchange rates of developed countries is unsuitable for a developing country like Mongolia.

Related legal provisions:

- Article 47.14 of the Minerals Law

Recommendations:

Replace sales value/benchmark price-based mining royalty calculation with a method based on profit and earnings before interest, taxes, depreciation, and amortization. Reduce the ETR tax policy to close to the international standard of 40–50 percent. Remove the staged royalty system. If a full transition to a profit-based method is unfeasible, consider implementing a profit-based method on surtax and special royalties as a starting point.

THREE. WITHHOLDING TAX

High tax pressure for non-residents:

- A 20 percent WHT is levied on all payments to foreign investors on gross proceeds, from technical service to interest and dividends. This is considered a major burden. Services obtained abroad are typically due to a lack of local expertise, knowledge, experience, and skills, often involving professional experts. This indirectly hampers investment in domestic intellectual property and human resource development.

- Mongolian businesses ultimately bear the tax cost through a "gross-up" mechanism, most commonly for service payments. In other words, this regulation loses the intended meaning of "withholding". It operates similarly to VAT, imposing an additional burden on domestic entities by not being deducted from the service cost but added on top.

- For resident entities, income tax is imposed on net profit in respect of the sale of shares. However, according to Article 18.6 of the CIT Law non-resident legal entities, the tax base for income from the sale of stocks, bonds or other financial instruments, apart from the income derived from the Mongolian Stock Exchange (MSE), is determined without considering the original investment/purchase price paid by the investor and tax is imposed directly on the total amount of the sale.[1] This can result in income tax being owed even when the shareholder sells its shares at a loss. Further, as a basic example, if an investor invests US$10 million in the share capital of a Mongolian company and later sells its shares for US$12 million the 20% income tax imposed on the gross proceeds of US$12 million (US$2.4 million) is equivalent to a 120% tax rate on the investor's profit of US$2 million. If those shares were sold for US$15 million the tax would be US$3 million, equivalent to a 60% tax rate on the profit of US$5 million – an excessively high effective tax rate.

- If Mongolia has a double taxation agreement with the non-resident's country, the withholding tax rate of 20 percent may be subject to reduction based on the type of income outlined in the agreement. However, the CIT Law does not specify the procedure for reducing the tax rate, leading to varied interpretations of double taxation agreements by tax officials, which complicates implementation.

Related legal provisions:

- Article 18.6 of the Corporate Income Tax Law
- Articles 4.1.7 and 20.2.4 of the Corporate Income Tax Law

Recommendations:

To provide for the taxation of the profit (not the gross sales proceeds) earned on the sale of all shares and other securities as is currently provided in respect of securities listed on the MSE. To reduce the WHT to 5–10% depending on the nature of the payments. To eliminate the 20% WHT for service payments provided outside of Mongolia by non-residents. The Corporate Income Tax law needs to specify the procedure for reducing the tax rate, to avoid varied interpretations of the Double Taxation Agreement by different tax officials, which complicates its implementation.

[1] *Taxing the gross payment is appropriate and common international practice in respect of dividends, interest and similar items of income of the non-resident. The inclusion of gross sales proceeds from the sale of shares in this category of income is contrary to basic fairness (tax should be on the profit earned) and international practices.*

FOUR. VALUE-ADDED TAX

Unrecoverable VAT costs:

- VAT should be neutral to businesses. However, Mongolia uses it in many ways as an essential part of CIT. Businesses bear numerous forms of unrecoverable VAT costs.

- The input VAT incurred during the development phase is unrecoverable, resulting in a 10 percent increase in capital costs in Mongolia, which significantly discourages new investment or expansion in the mining sector.

- Mongolia "practically" disallows VAT refunds, and it is very difficult to offset VAT receivable against other tax liabilities, often leading to losses. Although input VAT incurred during the production phase is recoverable under the VAT Law, it is not refunded or offset against the taxpayer's other tax liabilities for extended periods (5–10 years).

- When the recoverability of input VAT functions in 18 mining countries was analyzed, results showed that 72 percent of these countries have effectively implemented the recoverability of input VAT. Although Mongolia has provisions for the recoverability of input VAT, these have not been implemented.

- According to Article 5.2 of the VAT Law, entities whose sales have reached 50 million MNT or more shall pay withholding VAT. However, the Law of Mongolia on the Support of Small and Medium Enterprises and Services Article 5.1.1 defines a micro industry and service provider as a business entity with an annual sales income of up to 300 million MNT. Article 5.1.2 defines a small industry and service provider as a business entity with annual sales income of 300 million MNT to 1 billion MNT. Article 5.1.3 defines a medium industry and service provider as a business entity with an annual sales income of 1 billion MNT to 2.5 billion MNT. Due to these alternative definitions, there is a disparity in understanding between businesses and tax authorities.

Related legal provisions:

- Articles 14.1.5.b, 14.6.5, and 15 of the VAT Law

Recommendations:

Making the VAT system neutral to businesses is recommended to create a more favorable investment climate. Allow legitimate VAT refunds and establish a clear process for offsetting VAT receivable against other tax liabilities.

It is crucial that the tax treatment permits the recoverability of input VAT as early as possible to foster ongoing investment in mining projects. Therefore, Article 14.6.5 of the VAT Law should be removed, and the Mongolian Tax Authority (MTA) should refund input VAT as soon as it is verified by tax inspection.

It is essential to enhance the VAT reporting system. For instance, the report format lacks clarity, and the current system records returns twice when documenting sales returns. Furthermore, VAT should not be recognized when payment is not received in full, specifically in the case of advance payments. It is essential for the legislation to clarify that VAT will only be calculated on the total amount once payment has been completed in its entirety.

The requirement to remit 10 percent VAT poses a significant challenge for micro and small enterprises and businesses in their start-up and project phases, particularly those generating annual sales revenue of 50 million MNT or just over 4 million MNT monthly. Consequently, it is recommended that the threshold for VAT registration be adjusted to 300 million MNT.

FIVE. REVERSE CHARGE VALUE-ADDED TAX

Compromised neutral effect mechanism of reverse charge value-added tax:

- The neutral effect mechanism of RCVAT is compromised in Mongolia. RCVAT charges are often shifted onto local entities, which end up bearing the tax burden.

Imposing RCVAT on services from abroad increases the cost of services for domestic businesses, reduces their income and profit, and decreases the amount of future investments.

Related legal provisions:

- Article 16.1.2 of the VAT Law

Recommendations:

Amend relevant legislation allowing businesses to deduct RCVAT as VAT credit, ensuring VAT neutrality and preventing tax burdens from being unfairly shifted onto local entities.

SIX. TAX DISPUTE MECHANISMS

Immediate bankruptcy risk resulting from Mongolian Tax Authority (MTA) practices:

- The practice of demanding the full tax audit assessment amount without waiting for finalized dispute resolution is unacceptable. No such practices are found around the world.

- Article 97.1.2 of the General Administrative Law states that the implementation of an administrative act may not be suspended if the purpose of the act is to collect tax from a citizen or other individual. It is necessary to change the practice of directly claiming the amount of the act in the General Tax Law with the provisions of Article 97.1.2 of the General Administrative Law. This provision also gives the MTA the right to directly assert and recover tax debts, regardless of the legality of the contested tax.

- While incorporating aspects of a judicial procedure in line with the preliminary ruling process, the Dispute Resolution Council (DRC) adjudication process exhibits elements that conflict with the principles established in the General Administrative Law and the General Tax Law. For example, according to Article 47.11 of the General Tax Law, if the relevant conditions are met, the DRC may suspend the disputed act for up to three months and order a new act to be issued. The tax authorities are afforded the chance to rectify their errors, thereby exacerbating the taxpayer's legal circumstances. The lack of detailed regulations related to this decision creates conditions for the tax authorities to behave arbitrarily. Incompletely performed actions and poorly made decisions have a negative impact on the interests of taxpayers. It is necessary to review Article 47.11 of the General Tax Law and incorporate provisions that outline specific conditions.

- The MTA threatens to close bank accounts before a dispute outcome, leading to substantial operational disruption and potential insolvency for businesses. Such actions are unlawful and contravene the pertinent provisions of the Constitution of Mongolia that safeguard the rights of citizens and businesses to submit grievances to the government and seek resolution through the judiciary.

- In accordance with Section 47.3 of Article 47 of the General Tax Law, taxpayers are required to remit only 10 percent of the unrecognized tax amount specified in the tax act, capped at 100 million MNT. The obligation to pay the entire amount assessed during a tax audit creates significant financial strain for taxpayers, leading some to face the possibility of ceasing operations or encountering bankruptcy.

- After reviewing data from 2023, it is evident that merely 10 percent of all disputes were adjudicated in favor of taxpayers. This indicates that the dispute resolution process is disproportionately biased and highlights the insufficient independence of the DRC.

- The General Tax Law stipulates that when determining penalties for taxes that have been paid and those that have not been paid within the designated timeframe, it is essential to incorporate provisions stating that the cumulative fines and penalties must not surpass 50 percent of the indicated tax amount. Currently, the General Tax Law does not impose any cap on penalties. By instituting such limitations, the General Tax Law will align with the principle outlined in the Civil Code that the total penalties should not exceed 50 percent of the value of the unmet obligation, thereby upholding the principles of fairness and safeguarding taxpayers' interests.

Related legal provisions:

- Articles 43.3 and 47.3 of the General Tax Law
- Article 97.1.2 of the General Administrative Law

Recommendations:

To improve Mongolia's international reputation and provide stability for businesses, ending aggressive enforcement practices such as demanding the full tax audit assessment amount without waiting for finalized dispute resolution is recommended. Increasing the engagement of non-governmental professional representatives in the DRC is paramount. This effort should focus on eliminating discrimination, improving fairness, increasing the frequency of the council's activities, and revising dispute review and resolution procedures. There is a general recommendation to permit deposits of up to 100 million MNT to be made directly into bank accounts rather than being routed through the MTA's state fund.

SEVEN. HOLDING STRUCTURE

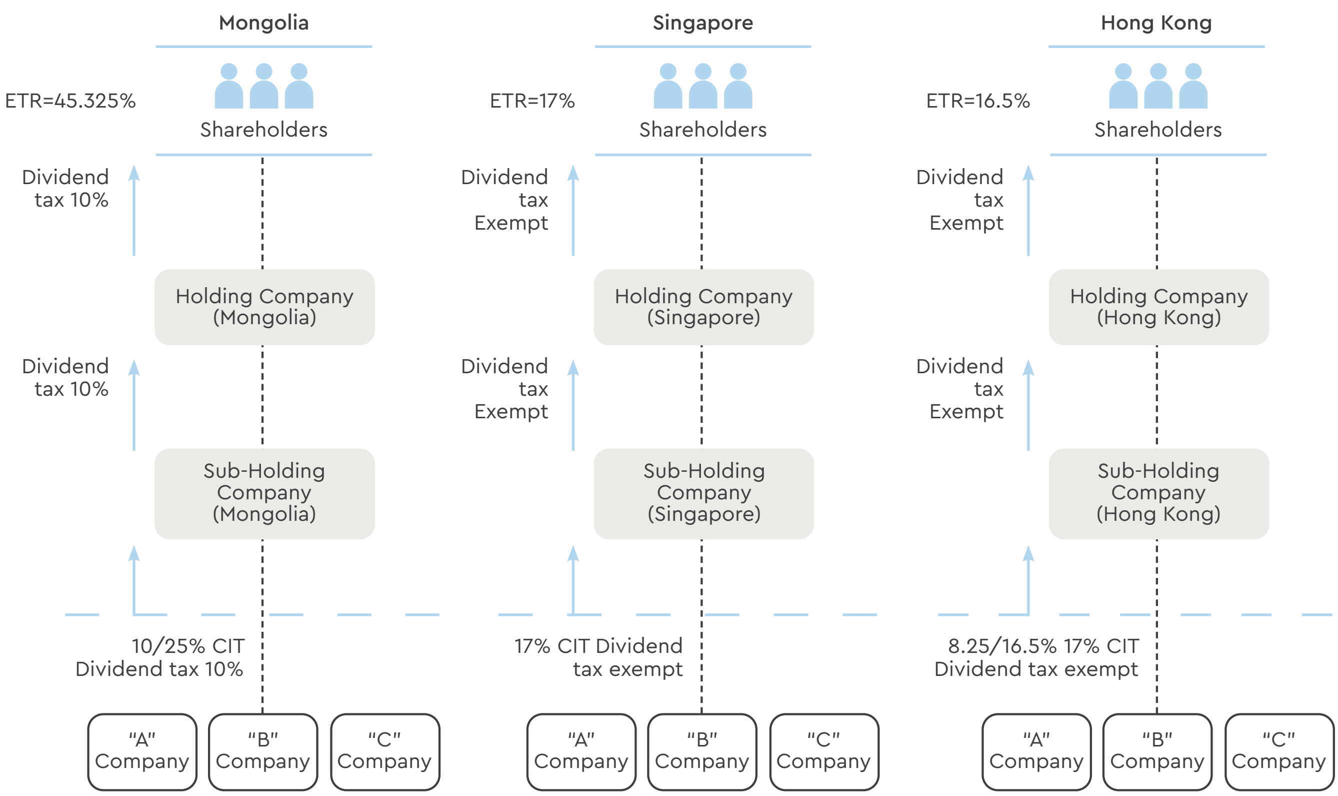
Unfavorable tax environment for holding companies:

- Mongolian group companies that require multiple layers of holding functions are subjected to a tax burden resulting in an ETR of approximately 50 percent due to the absence of a suitable regime for holding companies. This situation severely limits growth opportunities for group companies.

- The holding structure of foreign investors is not fully understood. AmCham has repeatedly observed the demand for full tax audit assessment amounts, incorrect determinations of the beneficial owner, and threats of freezing the bank accounts of foreign-invested companies before a dispute is finally resolved.

- The definition of an ultimate holder tends to be ambiguous and difficult to understand. It is unclear which level of the shareholding chain one must reach determine the ultimate holder, and there are practical difficulties in determining, registering, and monitoring the ultimate holder for a joint-stock company. Thus, international guidelines should be followed.

- The terms "beneficial owner" and "ultimate holder" are recognized internationally. However, the translation of "ultimate holder" in the General Tax Law diverges from definitions provided in the Law on Combating Money Laundering and Financing of Terrorism and the Banking Law. Such discrepancies have led to a distortion of the original meaning and introduced ambiguity, creating numerous challenges for practical application. The General Tax Law and the Law on the State Registration of Legal Entities mandate that any alteration to ownership by the beneficial owner or ultimate holder must be reported to the State Registration Office. This requirement introduces bureaucratic challenges and complexities for large corporations, particularly those whose shares frequently fluctuate on international stock exchanges.



Related legal provisions:

- Article 6.1.48 of the General Tax Law
- Article 3.1.6 of the Law on Combating Money Laundering and Financing of Terrorism
- Articles 10.3 and 10.1.14 of the Law on the State Registration of Legal Entities

Recommendations:

It is recommended that a suitable tax regime be established for holding companies. This regime should eliminate intercompany dividend and capital gains tax, thereby reducing the overall tax burden and fostering a more conducive environment for business expansion. When defining the "ultimate holder" of holding companies, international guidelines need to be taken into consideration. According to the OECD and UN Model Tax Convention, the fundamental criterion for determining the beneficial owner is defined as a person who is not restricted by contractual obligations concerning the right to utilize the income received. Furthermore, this individual has the capacity to assign the right to benefit to other parties and can freely manage the income as they see fit, as specified in articles 12.1–12.5.

The term "beneficial owner" is internationally recognized. It is recommended that the translation (ultimate holder) in the General Tax Law be corrected to match the definitions in the Law on Combating Money Laundering and Financing of Terrorism and the Banking Law or that references to these laws be added for consistency. This will clarify which level of the shareholding chain determines the beneficial owner.

The current taxation system creates significant difficulties for foreign investors, adversely affecting their operational efficiency and complicating the process of attracting and retaining investment. A corporate group may have a complex, multi-layered structure based on business activities. However, the ultimate shareholder is liable for dividend taxes at each layer to receive profits generated by the subsidiary below. In a group structure, dividends distributed are subject to 10 percent WHT at every layer of the chain, effectively increasing ETR by 10 percent at each layer.

Within a group of companies, revenue-generating entities and cash-deficit entities (such as those in the exploration or research phases) face financial difficulties and limited growth opportunities due to the lack of a financial management/holding company tax environment, which prevents efficient internal capital financing without additional loan costs. Arrangements should be made to ensure the tax exemption of distributed dividends and income derived from the buying and selling of shares among group companies. Formulating a tax framework for holding company structures can optimize tax responsibilities and foster a conducive environment for domestic and international investors to sustain their operations.

Related legal provisions:

- Articles 4.1.7v, 18.6.8, and 20.2.4 of the Corporate Income Tax Law

EIGHT. PROGRESSIVE INCOME TAX

Unsuitable progressive income taxes on the middle class:

- The higher rate of the progressive PIT targets highly educated and skilled workers earning over 120 million MNT annually. This tax structure is unsuitable for current socio-economic conditions, contributes minimally to state revenue, and results in a shortage of skilled professionals.

- Imposing a 20 percent progressive tax on wages and salaried income is unfair, especially when the middle class in Mongolia has not yet stabilized. This practice demonstrates tax discrimination, imposing a higher tax on wage and salary income while wealthy individuals mainly earning passive income through dividends and interest income pay only a 10 percent tax.

- Imposing a 20 percent tax on income derived by non-resident individuals from Mongolian sources is considered high. Consequently, this legal provision discourages non-resident individuals from conducting business activities or investing in Mongolia.

Related legal provisions:

- Articles 20, 21.1, and 21.2.5 of the Personal Income Tax Law

Recommendations:

Removing the progressive PIT system and bringing it back to a flat 10 percent rate is recommended to retain and attract skilled professionals. Lowering the 20 percent PIT rate on non-resident individual income to 10 percent is also advised.

NINE. STABILIZATION OF THE TAX ENVIRONMENT

Obstacles to tax certainty reduce investor confidence:

- The tax stabilization certificate within the framework of an investment agreement only stabilizes tax rates. However, this is insufficient as other factors can influence the taxable base, resulting in higher taxes despite stabilized rates. For instance, changes in asset depreciation methodology or deductible expenses can increase the taxable base, negating the benefits of stabilized rates.

- There are instances in which investors have yet to commit because they cannot reach a satisfactory agreement with the government regarding tax stabilization. The government's stance on stabilized rates is fixed on four tax types, while the investor is hoping for a stabilization by substance. This highlights the need for the government to address specific tax rates and broader tax implications when issuing tax stabilization certificates to fully ensure tax stability.

- Foreign investors consider the current regulations regarding a stable tax environment inconsistent. The government's breach of agreement obligations makes Mongolia less attractive to foreign investors.

Related legal provisions:

- Articles 3.1.7 and 3.1.8 and 14 of the Investment Law
- Article 6.1.50 of the General Tax Law

Recommendations:

A favorable, stable, clear, and advantageous tax environment for foreign and domestic investors must be created. The tax environment should be stabilized in its substance rather than the current approach of stabilizing tax rates only for selected taxes. The government should stabilize certain tax rates and tax implications when issuing tax stabilization certificates to fully ensure stability.

TEN. TAX INCENTIVES

Poorly targeted incentives and implementation issues:

- Despite legal provisions guaranteeing tax stability, practical implementation often falls short, leading to uncertainties and financial risks for investors.

- Current tax incentives are not well-targeted and fail to effectively attract and retain investment. In alignment with international standards, numerous tax incentives and discounts are offered to businesses to bolster the economy. To qualify for a tax credit in Singapore, entities must engage in genuine and substantial activities within Singapore, maintain a specified level of domestic business expenditures, and employ skilled personnel.

- Section 11.2 of Article 11 of the Investment Law stipulates that imported machinery and equipment may be exempt from customs duties throughout the construction period. Value-added tax may be levied at a rate and amount of up to zero, offering investors tax incentives to establish a construction material factory. The right to exemption has yet to be applied in the production of construction materials, as stipulated in Article 11.3 of the Investment Law, which states, "The support extended to investors as outlined in Articles 11.1 and 11.2 of this law shall be governed by tax legislation." Additionally, Article 4.1 of the General Tax Law asserts, "The State Great Khural possesses the authority to create, amend, or repeal tax laws."

Related legal provisions:

- Articles 10, 11, and 12 of the Investment Law
- Article 4 of the General Tax Law

Recommendations:

Revisiting the overall tax incentive system across all industries to improve its effectiveness and investor appeal is highly recommended. Moreover, there is a need to eliminate tax discrimination in the mining sector. Mongolia needs to consider global best practices, where various tax incentives are offered to entities to boost the economy, given that these entities carry out substantive, high-value activities, and commit to certain levels of local business spending and skilled employment. In addition, it is imperative to finally initiate the execution of tax support available to investors for the development of construction material manufacturing facilities.

CONCLUSION

AmCham Mongolia undertook a comprehensive analysis via its Tax Working Group, composed of representatives from member organizations, and incorporated further insights from its Legal Committee to produce this Position Paper. This effort led to identifying 10 significant issues impacting the current tax landscape in Mongolia. Mongolia's regulatory framework is not only intricate but also imposes considerable financial burdens on businesses in operation.

Tax environment stabilization presents the benefit of enhancing the level of investment flowing into Mongolia. There is a significant need for coherence between the State Great Khural, the Government of Mongolia, and pertinent governmental bodies to implement comprehensive legal framework changes. Within the scope of tax reform, a joint effort should focus on addressing the challenges encountered by private-sector enterprises, which serve as the foundation of the economy.