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Transfer Pricing Regulation in Mongolia

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Abstract

The transfer pricing mechanism is a tool commonly used to transfer the tax base from countries with high taxation in countries with low taxation. In many countries, this financial operations generate significant tax revenue losses. In an attempt to limit tax revenue losses, many public authorities have introduced regulations on transfer pricing, but the effectiveness of these rules has proved limited, and they contributed to the increasing complexity of tax laws and to the appearance of additional costs for companies.
Historically, transfer pricing (TP) was not a substantial issue in Mongolia. The tax legislation contains basic TP rules, but there is limited guidance and enforcement in practice. At the moment, Mongolian tax authorities are not conducting specific transfer pricing audits. Nevertheless, tax authorities are starting to pay more attention to transactions between related parties and potential transfer pricing adjustments. This study examines a transfer pricing regulations of Mongolia.

Keywords: Price Fairness, Transfer Pricing Regulations, Arm's Length Principles, Mongolian Tax Authorities
JEL Classifications: F10, F13, F18

Ⅰ. I. Introduction

In today's global markets, companies may produce goods and services domestically and sell them internationally or produce them outside the country and sell them here. As the number of multinational enterprises increases, the number of transactions between entities belonging to the same multinational group rises as well. Intercompany transactions generally offer the opportunity to shift income from one jurisdiction to the other. Income shifting can be driven by tax aspects, and differences in tax laws can be the leading determinant of transfer pricing choices. At the same time, profit shifting imposes risk to governments as it may reduce tax revenues. More and more governments are therefore introducing and extending transfer pricing regulations in

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order to combat profit shifting through intercompany transactions.

Without an effective response to transfer pricing issues, there is a risk in taxes revenues, and therefore the ability of such country to finance development. For this reason, clearer guidance on the policy and administrative aspects of applying transfer pricing analysis to some of the transactions of multinational enterprises (MNEs) are more important in many countries including Mongolia.

The fast expansion of Mongolia's economic and business growth fueled by such industries as natural resources, construction, agricultural in the recent years have been attracting significant attention from investors worldwide. As a result of foreign direct investment (FDI) in Mongolia in the past decade, 12,000 joint ventures and wholly foreign-owned companies from 112 countries were registered in Mongolia, with the total direct investment reaching $17 billion as a December 31, 2015 since 1995.

Mongolia's minerals sector has been the main driver of the country's rapid economic growth: it currently accounts for 18.6 per cent of GDP and approximately 80 per cent of exports. In recent years, the sector has been responsible for over 70 per cent of new foreign direct investment (FDI) into Mongolia. It is also increasingly important to the state budget, accounting for approximately 30 per cent of government revenues.

The minerals industry has evolved into a truly global industry that is highly competitive, generally capital intensive, technologically complex, and risky. The industry has been increasingly influenced by a limited number of well-financed and technologically advanced international mining companies. These companies are highly selective, risk averse, and sensitive to changes in the investment climate. Mining investors should also be able to rely on the certainty and stability of tax rules. Mongolia competes with other countries to attract investment in its capital-intensive mining sector, and therefore it is important that its tax regime be internationally competitive by embracing best practices.

But favorable fiscal regime and investment incentives for foreign direct investment can influence to choice of transfer pricing policy.

II. Mongolian investment environment

Mongolia has established one of the favorable and internationally competitive fiscal regime. Core elements of Mongolia's fiscal regime include corporate income tax, VAT, the royalty, and fiscal stability.

- Corporate income tax rate 10%, 25%. Up to MNT 3 billion a marginal rate@y 5% + progressive royalty (0%-5%)
- The tax system in Mongolia is based on self-assessment, so the burden of proof is on the taxpayer. Quarterly returns are due by the 20th of the month following the end of the quarter. Tax is paid in advance by the 25th of each month.

The legal entity which is going to implement an investment project in Mongolia can obtain Stabilization certificate upon application if it meets the requirements specified in the Law on Investment of Mongolia (2013). Stabilization

Certification is a certificate issued by the Invest Mongolia Agency for the purposes of stabilizing tax rates for a specified period of time. The rates of the following four taxes are stabilized under the stabilization certificates from 5 up to 18 years depending in the size and target region of investment: corporate income tax, VAT, custom tax, and royalty.

To promote the investment flow into Mongolia the Parliament approved the investment law and that law allows fiscal regime stabilization for investors (who invest more than $255 million). Stability period can be up to 30 years. The Investment Law provides any entity whose investment value will exceed MNT 500 billion with an option to enter into an Investment Agreement with the Government of Mongolia. This agreement may stipulate a longer stabilization period than the timeframes set in the Investment Law, as well as tax stabilization terms and other financial incentives and benefits.

The Investment Law provides investors with a variety of other tax and non-tax benefits from Mongolian Government. The tax benefits may include exemption from taxes, preferential tax treatment, accelerated depreciation and amortization that is deductible from taxable income, carrying forward of losses, and deduction of employee training expenses from taxable income.

In Mongolia a holder of a mining license who undertakes to invest at least US$50 million during the first five years of its mining project can enter into an investment agreement with the government to provide a stable operational environment, including a stable tax environment. With respect to fiscal stability, the mission makes the following recommendation:

- On a going forward basis, Mongolia's investment agreements should include a fiscal stability clause that would be limited to 15 or 20 years and cover only the capital recovery rules, the income and withholding tax rates, royalty rates, and a maximum rate on import duties. Any other tax law change that affects businesses generally and that does not discriminate against mining would apply.

But has some challenges in the enforcement of law. Such as, up to date regulations in monitoring the fairness of transactions in the industry (transfer pricing rules).

Tax losses in the infrastructure and mining sectors are able to be carried forward and deducted from taxable income for four to eight income years following the year in which the loss was incurred. Tax losses in other sectors are able to be carried forward and deducted from taxable income for two years following the year the loss was incurred. However, the tax loss utilized may not exceed 50 percent of the total taxable income in that year.

There is no initial capital required for establishing a local entity. The minimum capital required for a foreign invested company in USD 100,000.

Ⅲ. Transfer pricing regulations in Mongolia

While transfer pricing concepts and rules have been adopted by Mongolia since 2007, they remain at a developmental stage.

Transfer Pricing rules in Mongolia are addressed in the General Tax Law, the Corporate Income Tax law, and the Value-added Tax law.

Another main transfer pricing guidelines in Mongolia is Finance Minister's decree No.86, 2007. By this decree, the transfer pricing regulation 'Methodology to use benchmark price' was approved. That was followed by the Commissionaire Decree No. 165 of the General Department of Taxation 'List of source information on fair market value for transactions between related parties using unrealistic prices' for determining arm's-length price in related-party transactions.

1. Arm's length principle

Almost all tax codes worldwide contain anti-avoidance regulations with respect to the conditions of intercompany transactions. Such anti-avoidance regulations are mainly based on the arm's length principle. It supports an equal treatment of independent companies and those part of a multinational enterprise which avoids the possibility of tax loopholes and the creation of market distortions.

By General Taxation law, the tax authorities started using the arm's-length concept to determine fair market value in related-party transactions, as well as in unrelated-party transactions not made at arm's length. General Tax law gives the right to the tax administration to apply an indirect method in determining tax liability of a taxpayer, if it established that a taxpayer has used unrealistic or not 'arm's-length' prices in their transactions.

The law defines two types of indirect methods for determining the value of a transaction for tax purposes. 'Fair value method' is used in determining fair value in related-party transactions by comparing and estimating prices that are applicable in normal market conditions; while 'benchmark price method' is used in establishing fair value in unrelated-party transactions through comparison of operations, income, expenses and other documents of a taxpayer that is in a similar capacity, and in a similar condition to the taxpayer in question.

2. Related parties/unrelated parties

As follows from the arm's length principle, transactions under consideration are those between related parties. Such related parties may either be located in the same country or abroad. In addition, some countries treat unrelated parties in tax havens as related parties. The majority of countries apply transfer pricing regulations to domestic and foreign related parties.

Mongolian transfer pricing rules focus on transactions between related parties and that are applied to the following transactions:

- Transactions between related parties.
- Transactions between unrelated parties not dealing at arm's length.
- Barter transactions.
- Transactions involving netting off receivables and payables.

Corporate Income law (Art. 6.1) provides that related parties are entities with following relations to the taxpayer:

- holds 20% or more of the common stock;
- has the right to receive 20% or more of the dividends and distributions,
- has the right to appoint 20% or more

of the management of the economic entity or is otherwise able to determine its policies.

However, Art 48.4 of the General Tax law provides for a broader definition of related entities for transfer pricing purposes, which is 'entities authorized to directly and indirectly participate in management, control and property rights of any foreign and Mongolian legal entities'.

The transfer pricing provision in the Corporate Income Tax law provides that "If related parties have sold or transferred goods, performed work, or rendered services among themselves below or above fair market value, the tax authority shall determine gross taxable income of such goods, work and services based on value involving transactions of similar goods, work and services among non-related parties" (Art. 11.1). This provision is applied only to the related parties defined within this law.

3. Transfer pricing methods

Based on the arm's length principle, several methods have been established in order to determine the appropriate transfer price for a certain transaction. In its 1979 report, the OECD has introduced three traditional transaction methods (the comparable uncontrolled price (CUP) method, the resale price method (RPM), and the cost plus method) with a clear preference for the CUP method. In the early 1990s, the OECD also extended its recommendations. In the Transfer Pricing Guidelines published in 1995, besides the traditional transactions methods, two transactional profit methods (transactional net margin method (TNMM) and profit split method) were included, which define prices based on different profit allocations.

The Mongolian Finance Minister's decree No.86, 2007 approved three methods for the determining arm's length principles in Mongolia. The regulation provides only for traditional transactional methods – comparable uncontrolled price (CUP), cost plus (CP), and resale price method (RPM) – for determining fair market value.

Under the CUP method, the price of an uncontrolled transaction is compared with the price of a controlled transaction. An uncontrolled transaction implies that the parties involved are not affiliated and are themselves not part of a group. The major requirement of the CUP method is the comparability of transactions.

Under the resale price method, in order to find an arm's length price, the resale price obtained by a distributor is reduced by an appropriate gross margin. The appropriate gross margin can be found with reference to transactions with unaffiliated companies (internal comparable). In case, such a comparison is not possible, the gross margins of other individual distributors of similar products may be used (external comparable). The method is based on the assumption that gross margins are comparable for all products. This implies that products and circumstances of the transaction must be similar - under US regulations even higher standards of comparability are required than for the CUP method.

The cost plus method is very similar to the resale price method, but takes the perspective of a manufacturer selling similar products to affiliated and unaffiliated companies. It adds an appropriate cost plus mark up to the costs of goods sold to find an arm's length price.

4. The List of price information

By the Commissionaire Decree No. 165 of the General Department of Taxation, 'List of source information on fair market value for transactions between related parties using unrealistic prices' for determining arm's-length price in related party transactions was released. The list specifies the resources for determining the fair market value for agricultural products, building materials, lending services and mining products. Resources are maintained by websites of different government agencies, such as the National Statistical Office, Customs office, Bank of Mongolia, etc. The regulation states that supervision on 'benchmark price' shall be implemented by the General Department of Taxation, General Customs Authority, and State Professional Inspection Agency (supervisory bodies).

Per the regulation, supervisory bodies are provided with the rights and obligations such as:

- Determining types of goods, work and services that could be conducted at an unrealistic price, collecting information on market prices of particular goods, work and services from the relevant sources, and conducting price trends' observations and surveys on a regular basis.
- Obtaining information on market prices from stakeholders, government and nongovernment organizations, international organizations and other data sources.
- Overseeing non-benchmark pricing through observation findings and surveys or reviewing compliance with the tax and customs' legislation of Mongolia.

5. Documentation Requirements

In order to monitor the transfer pricing policy of multinational companies, tax authorities in most countries require detailed documentation. The preparation of sufficient documentation is especially important as in most countries the burden of proof will then rest on the tax authorities. It may, however, switch to the taxpayer if documentation is incomplete or inaccurate. As detailed country-specific information is not available and only hard to assess, the exact content of the requested documentation in each country is difficult to capture. Lists of required documents may exist, but it is not always clear whether such lists are enforced in practice.

The key transfer pricing challenge of the tax authorities remains the lack of transfer pricing resources, which is the main focus of Mongolian Tax Authority (MTA). The tax authorities are likely to continue to seek appropriate transfer pricing resources by establishing new transfer pricing specialist groups within the MTA with an aim to exclusively deal with transfer pricing compliance.

There is no requirement to provide transfer pricing documentation to the Mongolian tax authorities. Only large taxpayers reporting to the large taxpayers' office are required to disclose in their

Corporate Income tax return, information on shareholders, subsidiaries and affiliates, financial transactions between related parties including details, exchange of goods and liabilities between related parties.

In addition, per transfer pricing regulation ('Methodology on benchmark price'), a taxpayer shall compile the following documents each time when selling goods, executing work and rendering services (Art. 4.2):

- Documents describing type of transferred goods, works and services, contractual terms, affiliation status of entities.
- Documents describing price estimation methods, external and internal factors influencing price.
- Documents describing strategy and policy for pricing and profit allocation.

6. Tax authority

Once tax reports are submitted to the tax authority, they are reviewed for factors such as internal consistency, calculation errors, timely payments and compliance. In addition, audits are conducted by the tax authority to test the accuracy and completeness of reporting. Taxpayers are required to grant tax inspectors full access during these audits and the audit should be witnessed by an independent person.

7. Penalties

In order to enforce the correct handling of tax regulations, many countries impose penalties. Besides penalties on the wrong determination of taxable income, regulations may also include penalties on wrong or incomplete documentation. Most countries apply general tax penalties to transfer pricing cases, but some countries have introduced special transfer pricing penalties, especially with respect to documentation. The OECD member states have agreed to not impose substantial penalties on taxpayers who have acted in good faith.

At the moment no specific penalty provisions for breach of Transfer pricing regulations exist in Mongolia. General penalty provisions in Art 74 of General Tax law will apply for breach of transfer pricing rules.

IV. Conclusions

This paper intends to explore transfer pricing regulations in Mongolia. Its transfer pricing regulation is very basic, with no details. The regulation describes only traditional transactional methods (CUP, CP and RPM) for determining fair market value with no guidance on comparability, functional analysis. However, the Mongolian tax authority has the power to determine taxable income arising from transactions between related parties based on comparable transaction between non-related parties if it considered that the amount charged is above or below fair market value.

There are, however, several steps that a country can take to provide greater certainty and to limit abusive transfer pricing.

First, Mongolia should adopt and follow the OECD guidelines for transfer pricing, which would provide taxpayers with more certainty. These guidelines could be adopted in regulations by reference.

Second, companies should be required to disclose related party transactions on a schedule attached to their income tax returns. There should be an appropriate penalty for failure to disclose these transactions.

Third, companies should be required to contemporaneously document how they establish their transfer prices for transactions in excess of $1 million. This documentation would be provided to the tax auditor on request.

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