

Reform of the Mongolian Corporate Income Tax

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Introduction

This Report reviews the Economic Entity and Organization Income Tax Law of Mongolia (effectively, the corporate income tax or CIT). In particular, it considers proposals to end the dual rate structure in the law and technical shortcomings of the law. The law currently applies a 15% tax rate to income up to 100,000,000 Tgs and a 40% tax rate to income of 100,000,000 and above. In addition to the progressive rate scale applied to general business income, specific rates apply to particular types of income. These rates sometimes apply to gross receipts and sometimes to net gains. The legislation provides two sets of specific rates, one for resident taxpayers and another (generally higher) for non-residents.

An important issue that underlies concern over the dual rate system is the desirability of achieving revenue neutral reforms. Because revenues are as dependent on the base as on the rates applied to the base, consideration of rate reform necessarily entails a review of income tax base issues, particularly tax concessions.

It also necessarily entails a review of the interaction of the CIT and personal income tax (PIT). Taxpayers in many instances have the option of operating a business in corporate form or as an unincorporated enterprise. Similarly, they have the option of holding financial assets directly or through a holding company. And finally, they have the option of realising retained profits as dividends, as distributions upon liquidation of the company, or as a capital gain through a sale of the company. The tax picture of income derived through a company can only be fully understood if the interaction of the CIT and PIT is considered.

And finally, the effect of Mongolia's international tax treaties must be considered. Mongolia currently has 33 international tax treaties. Moreover, some of the treaties have been adopted in part for political recognition reasons as there is limited trade between some treaty partners and Mongolia. However, Mongolia does have a number of treaties with some jurisdictions in which key investors are resident. To the extent existing treaties limit Mongolia's taxing power, their impact must be considered. To the extent Mongolia will likely expand its international tax treaty network in the future, it is important to develop a treaty policy that is compatible with and consistent with the reform of the CIT and to regularly review and renegotiate treaty terms that fail to reflect Mongolia's changing economy.

The Report reviews the technical features of the CIT law that establish the company tax base. It contains many recommendations for changes that should be incorporated into the CIT law. The current CIT law contains a large number of shortcomings. The Report repeats, in part, suggestions that have been made in a wide range of previous reports on the CIT including reports by Korean, Japanese, U.S., and IMF experts. Despite a proliferation of reports and recommendations over a period of more than eight years, none of the serious flaws with the current law have been addressed. The law remains a post-socialist law, drafted using socialist concepts in the very early stages of the transition to a market economy, and in many respects remains inadequate to deal with the current state of the market economy in Mongolia. Piecemeal tinkering and ad hoc amendments will not be sufficient to address the issues noted in

this and in previous reports. It is strongly suggested that implementation of recommendations in this Report should occur through adoption of a replacement model law rather than amendment of the current law.

Because many of the broad tax policy and tax design issues have been well covered in previous reports, particularly the Mann Report,¹ this Report does not revisit the economic analysis or conclusions developed in previous studies. Rather, it focuses on the technical measures that should be addressed in the course of CIT reform. Thus, for example, the Report does not review in great detail the concerns raised by many previous reports with respect to inefficient and counter-productive tax concessions. Rather, it sets out legislative solutions to inhibit further concessions and remove existing ones. Similarly, it takes as givens many observations in previous reports about the basic structure of the CIT and looks at the technical rules needed to achieve reform.

In the course of the project, General Department of National Taxation (GDNT) Officials requested the consultant to direct his attention to a large number of technical provisions in the tax law. As result, related areas that fall within the general scope of the project but not specified as priority matters by officials working with the consultant are touched upon only briefly in the Report. These include some tax administration issues such as the penalty structure and incentives and disincentives for performing and non-performing taxpayers respectively.

The Report is divided into two Parts. The first Part addresses broader conceptual issues related to tax reform and tax law amendment. The second Part addresses technical design issues raised by the GDNT in the course of investigation for the Report or that were exposed in the context of addressing other issues that were raised by the GDNT.

¹ Arthur Mann, *Current Issues in Mongolian Tax Policy: Final Report*, DAI for Economic Policy Support Project, May 31, 2000.

Implementation of the recommendations in this Report

This Report outlines proposals for amendment to the CIT law. The ideal reform program would be a “big bang” reform that entailed replacement of current income tax assessment and procedure laws with a new tax code. A second best alternative would be a new CIT law with ancillary rulings issued as a package. However, political realities and very limited administrative capabilities may preclude either of these options and a more realistic probability is gradual implementation of changes, commencing with rulings to explain current provisions that are not being applied adequately, followed by legislative amendments and accompanying rulings.

If this route is followed, it is essential that comprehensive rulings be prepared and distributed so taxpayers can be required to comply with the rulings and tax administrators can enforce the law consistently and fairly throughout the country.

Assistance should be sought with both the preparation of rulings and drafting of legislative amendments to ensure they conform to international norms and to ensure they anticipate the taxpayer responses that have been addressed in other jurisdictions enacting similar rules. The GDNT does not have the capacity at present to understand fully market economy legal arrangements and transactions that are commonly used to avoid tax elsewhere and the most effective way of developing this capacity will be to seek external assistance that combines ruling drafting with training. The ideal program would see external advisors working with representatives from both the Division of Tax Administration and Methodology and the Division of Training.

PART A

TAX REFORM AND TAX LAW DRAFTING

I. Development of a Tax Code; Tax reform process

This Report reviews the Mongolian CIT law. That law was drafted over the course of 1992 and adopted in 1993 as Mongolia began its transition to a market economy. The authors of the law had no previous exposure to market economy tax laws and no exposure to market economy tax terminology or market economy tax norms. The law is seriously ill-suited to the current needs of taxpayers and revenue authorities and is in need of complete replacement.

This Report address some of the most serious shortcomings of the CIT law and makes recommendations for immediate amendments to address the most serious problems. It remains the case, however, that replacement of the law with a modern CIT law would be a far preferable option. That is not the first choice, however. The ideal approach would be to modernise of all tax laws, not only the CIT law, and to incorporate all tax laws into a single tax code. The benefits from this approach are substantial:

- To begin with, it would provide the basis for common terms and definitions in all tax laws rather than the current inconsistent and sometimes contradictory use of expressions or application of concepts.
- Secondly, it would make coordination of the different tax laws simpler so there can be common tax bases used for different types of taxpayers.
- Thirdly, it would ensure there are no overlaps or gaps between tax laws.
- Fourthly, it would resolve conflicts between inconsistent tax laws.
- Fifthly, and most importantly, it would provide an opportunity for significant reform in terms of base broadening, reforming tax administration processes, and achieving considerable rate reductions.

Two of these points are addressed in more detail, below. Two further issues also looked at in more detail are the technical process of drafting amendments, a new CIT, or a comprehensive tax code, and steps needed to address the significant “operational gap” that lies between drafting a new law in GDNT headquarters and implementing its provisions in the field.

1. Inconsistency between laws

As noted above, one of the benefits that adoption of a tax code to replace all existing tax laws seeks could achieve is consistency between tax laws. This will not, in itself, address the problem of inconsistencies between tax laws and non-tax laws that contain tax measures. This can only be achieved in an overriding law and careful monitoring by the parliamentary legal office.

Inconsistency between tax and non-tax laws is particularly a problem in Mongolia because there appear to be established canons of interpretation that the courts could use to address such inconsistencies, unlike the case in mature market economies.

An example cited time and again by representatives from the GDNT and others outside the department is the provision in the Mining Law which allows for the carryforward of losses for tax purposes. Prima facie, this provision has no effect as a result of the General Taxation Law of Mongolia which states that tax deductions are governed solely by tax laws.² A similar issue arises with the provision in the Mining Law that deals with deductions of research and development expenses.

Consolidation of tax laws into a single code would address inconsistencies between tax laws but it would not address inconsistencies with other laws. One view is that taxpayers seeking to rely on concessions in other laws have no standing giving the clear rule in the General Taxation Law of Mongolia that the tax provisions in other laws shall not be of effect. At the same time, it must be recognised that assurances by officials outside the GDNT that such provisions will apply may give rise to reasonable expectations on the part of taxpayers. The preferable solution is to delete all tax measures from non-tax laws and move them to the tax laws in the course of redrafting the tax laws.

2. Tax law redrafting as part of a tax reform process

As discussed further below, it will be difficult to achieve a substantial reduction in the corporate tax rate and alignment of physical person and corporation tax rates in a revenue neutral fashion without substantial base broadening. As noted below, replacement of the progressive rate structure for companies with a single rate would require a very high rate (36.7%) in the absence of base broadening. It is not possible to estimate the potential revenue gains from base broadening and administrative reform which could be used to achieve a much lower rate, but the revenue gains are likely to be significant. It is very clear that tax administration processes and tax collection energy focuses primarily on the 150 corporate taxpayers which provide 80% of the corporate tax base. Anecdotal evidence and visual evidence of conspicuous consumption suggests there has been far less success extracting tax on the basis of ability-to-pay principles from other corporate taxpayers, particularly companies that provide untaxed benefits to shareholders and owner/employees and relatives.

The progressive company tax rate scale and the absence of anti-splitting rules effectively means that with the exception of 150 large companies, both multi-owner and single owner businesses operates through corporate form pay a maximum of 15% on retained profits and savings (and possibly far less on consumption provided as untaxed company benefits). Given the relative ease with which a business can be incorporated, it is likely that employees unable to operate through corporate form are bearing a substantial part of the personal tax burden. The inequitable and inefficient distribution of tax burdens is clearly not sustainable in the long run and in the short run it may prevent adoption of a single rate for companies aligned with the highest physical person rate. A broad base, single low company tax rate, and alignment of the highest physical person rate with the company rate will set the stage for a neutral tax

² General Taxation Law of Mongolia, Article 2, paragraph 3.

regime that achieves an equitable, and publicly accepted, tax system that promotes efficient investment free of distortionary biases.

Experience abroad has shown that significant reform of this type – elimination of tax concessions in favour of a broad base and low rates, and alignment of company and physical person rates at a maximum rate substantially below the current maximum, requires reform of all aspects of the tax system. Lower rates must be accompanied by base broadening for companies and physical persons and substantial reform of the tax administration and collection process to ensure base broadening rules are effectively applied, particularly to privately-owned enterprises. Foreign experience has also shown that significant reform on this scale cannot be achieved in a piecemeal fashion.

The Canadian experience last decade is often cited as an example of the point. In the 1980s the government of the day first lowered tax rates and separately sought to broaden the tax base. In the subsequent election, the governing party was reduced from a strong majority to 3 seats in the parliament. By way of contrast, New Zealand, the United States, and Australia used tax reform “packages” to achieve genuine reform. Rate reductions were directly tied to base broadening and the elimination of tax concessions. As a consequence, the various interest groups seeking to retain concessions were effectively neutralized by the broader support for lower rates. It was widely understood that reform came as a package and dismantling of any base broadening measures such as the elimination of tax concessions would necessarily mean less room for a reduction in tax rates.

The Mongolian government is considering proposals to reduce the company tax rate in 2004, but not in the context of a comprehensive reform package. Consideration might be given to the announcement of proposals for rate reductions prior to a general election while work proceeds on the preparation of a comprehensive reform package that is introduced after the election.

3. External assistance with tax law drafting

The GDNT drafted the current CIT in 1992 with virtually no exposure to modern market economy tax principles or drafting norms. It has drafted amendments many times since without external assistance.

These efforts have been, in many senses, heroic. In fully developed market economies, tax amendments are prepared by large teams of experts with long experience and prior to enactment as law, amendments are often reviewed by a wide range of external advisers. In many cases, foreign experts from jurisdictions with similar rules are also consulted.

The taxpayers to which a CIT applies are among the most sophisticated in the world and they have access to the best tax planning resources available internationally. To reduce the risk of error or omission or inadvertent planning or avoidance opportunities, it is important that tax officials utilize all the expertise possible when drafting CIT amendments or new CIT legislation.

Recommendation:

It is very strongly recommended that external assistance be sought for any drafting of amendments or a new law. Assistance can be sought from many national aid agencies or the technical tax law drafting assistance office in the legal department of the International Monetary Fund.

4. Closing the gulf between the law and practice

A remarkable feature of tax administration in Mongolia is the enormous gulf between the understanding of the law in the GDNT headquarters, where the law is drafted, and its understanding in the field by tax officials responsible for administering and applying the law. Time and again examples arose where the central office had an understanding of the law that is not reflected at all in the field. At least one official in the GDNT national office believed the law already successfully with issues such as thin capitalization, distributions by way of liquidation, share cancellation, share buyback, share dividends, capital gains on the sale of shares, etc. However, GDNT officers responsible for collection reported that they did not attempt to assess taxpayers on gains in any of these situations as they were unaware of any provisions that dealt with them.

The problem may be illustrated with two examples:

A simple way for a taxpayer to realize the value of retained earnings in a private company is sell the shares in the company for a capital gain. The PIT law includes capital gains in the gross income of physical persons.³ However, neither the general rate section (which imposes a progressive rate scale),⁴ nor the specific rates section provide any rate for capital gains on shares.⁵ As a result, representatives from 21 aimag offices asserted with confidence that they do not assess capital gains on the sale of shares. While it is the view of an officer in the national office that there may be ways to solve this problem, the views have never been communicated to officers in the field.⁶

³ PIT Article 4, paragraph 1, subparagraph 5 includes capital gains in income (under an Article misnamed “taxable income” and Article 5, subparagraph 3(a) includes capital gains (presumably net gains) in taxable income.

⁴ PIT Article 7, paragraph 1.

⁵ PIT Article 8.

⁶ A representative from the national office suggested that a section that imposes a rate on gains realised on the sale of *immovable* property could also apply to intangible *movable* property. This analysis is unlikely to succeed if tested in a court of law, but in any case it can never be tested because field officers are not aware of the view of national office that it may be possible to apply the immovable property rate to intangible movable property. This view would be unlikely to succeed given the clear difference between immovable property and intangible movable property in law. Indeed, there is a viable argument that the immovable property rate section if challenged may be found to not work even in respect of immovable property. The rate for immovable property applies to “total income” (Article 8, paragraph 1, subparagraph 3) which is interpreted as gross receipts from the sale of property. However, this is a rate Article only and no provision brings this amount into income or taxable income as both the provisions that deal with what is income and what is taxable income only catch capital *gains*, which is a *net* concept.

An alternative way to realize the value of retained earnings in a private company is to liquidate the company or have the company repurchase shares or cancel shares. The definition of gross income in the PIT does include “gains” of shareholders⁷ and once again it was the view of at least one officer in the national office of the GDNT that this Article should be applied to all transactions with interests in companies. However, it appears that in the field the relevant Article has not been interpreted to include any amounts on liquidation, share buyback, share cancellation, reduction of capital, etc. There are two explanations for this. First, it is not clear that it was the drafter’s intention to catch all these specific types of company transactions in the general section and second, it is not clear how a general section could operate in respect of particular transactions each of which requires different rules for the calculation of cost base, gross proceeds from the transaction, and so forth.

This is arguably an area in which specific rules would be preferable to a general charging rule. However, in either case, the law itself will not suffice to give taxpayers and tax inspectors sufficient advice as to how the rule or rules should be applied in particular situations. Detailed regulations or public rulings will be needed to enable taxpayers to assume responsibility for reporting the correct amount of gains and to allow tax inspectors to assess reported gains correctly.

Recommendation:

To close the gulf between the understanding in the GDNT national office of how the law should operate in theory and how it is being applied in practice by officers in the field, detailed public rulings on the operation of Articles should be jointly developed by the national office and field officers and distributed to all officers and potentially affected taxpayers.

5. Self-assessment and a public and private rulings program

It was suggested in the previous section that detailed public rulings are necessary to bridge the operational gap between law designers and drafters in the national office and assessing officers in the field. The issue of public rulings raises a broader question regarding the ways in which the GDNT communicates information to taxpayers and tax officers.

At present, GDNT efforts are to a large extent focused on the 150 large taxpayers that generate 80% of corporate income. There are almost 100 times more companies that fall outside this band but they receive relatively little attention. Similarly, relatively few physical persons file returns. While the private sector economy is growing and the number of self-employed persons compared to formal employees is rising, collection efforts with respect to physical persons remain focussed on withholding from salary.

It is not possible for a tax office to apply the tax law to all persons in the country who derive what should be taxable income by individually assessing each person deriving income. A broad-based mass taxation system requires adoption of a self-assessment

⁷ PIT Article 4, paragraph 1, subparagraph 5(b).

system under which taxpayers are provided with full information on all aspects of determining their tax liability and are responsible for calculating their taxable income in the first instance. Four elements are essential for the successful operation of a self-assessment system:

- First, taxpayers must be provided with information on how to determine their tax liability through the use of a comprehensive public rulings program.
- Second, selective audit programs must be used to identify non-compliance.
- Third, effective penalties must be applied to taxpayers who fail to comply with their liability and the penalties must be publicized so potential avoiders are aware of the risks of non-compliance.
- Fourth, taxpayers with queries about particular transactions should be able to apply for a private ruling on the application of the tax law to their situation prior to entering into the transaction or prior to completing a tax return that reflects the transaction.

Ideally, taxpayers in a self-assessment system should have access to a comprehensive manual comprising public rulings on all aspects of the income tax. However, creation of a manual of this sort would involve a tremendous use of resources not currently available in the GDNT. A more practical program would be one that created public rulings on a regular basis which could collectively comprise a tax manual used by tax inspectors. Taxpayers could be provided with individual rulings relevant to their situation and tax inspectors could use the manual or complete set of rulings to carry out their assessment responsibilities.

Both the public ruling and private ruling system should be formally established by legislation and a ruling process established in the GDNT to ensure rigorous review of rulings prior to publication and to eliminate the risk of corruption or misuse of the ruling process. Since taxpayers are asked to rely on rulings to determine their liability, rulings should be binding on the GDNT. Public rulings should be binding until amended and private rulings should be binding for the particular transactions to which they relate, provided the taxpayer has made full and true disclosure of all relevant facts.

Over time, public rulings on the CIT should be consolidated into a CIT manual for tax inspectors.

Recommendations:

1. The General Taxation Law of Mongolia should be amended to provide for binding public and private rulings.
2. Rulings should be developed for current law and future amendments.

II. The CIT tax base and rate structure

1. Dual business income tax bases

Mongolian income tax is imposed through separate laws on entities and physical persons. Different tax bases are used for the two laws and different rate scales apply to the different categories of taxpayers.

Different *rate scales* for physical persons and for other entities is common, although tax designers often try to avoid significant misalignment between the entity rate and the highest physical person rate to prevent arbitrage and avoidance by persons who incorporate their businesses to take advantage of lower entity rates. It is very unusual to have different *bases* for the two types of taxpayers, however, as this is an invitation to arbitrage and avoidance by taxpayers able to move from one law to another.

The most common technique used to avoid this type of arbitrage is to have a single tax law that applies to both physical persons and entities. Where separate laws are used, the physical persons' tax base for income other than employment income (by definition, only physical persons can derive employment income) is usually derived from the entity tax law.

Recommendation:

The PIT and CIT tax bases for income other than employment income should be aligned. This can be done by adding a provision to the PIT that makes it clear that the rules set out in the CIT will be used to calculate taxable income other than employment income of physical persons.

2. Rate scale

The CIT adopts a progressive rate scale with a 15% rate applying to income up to 100 million tugrugs (US \$90,000) and a 40% rate applying to income above that amount. By way of contrast, the 40% rate cuts in for unincorporated taxpayers at 4.8 million tugrugs (US \$4,305). In other words, through the simple expediency of incorporating a business, a taxpayer can derive 21 times more income before he or she hits the 40% bracket. GDNT officials presume most high income individuals who are actually declaring their income for tax purposes adopt this easy method to legally reduce their tax liability to a fraction of what it would otherwise be. As soon as the income of an unincorporated business exceeds 2.4 million tugrugs (US \$2,152) there is a potential tax saving by incorporating.

A progressive rate scale is commonly applied to physical persons on the basis of an "ability to pay" philosophy. No similar philosophy applies to legal entities, as legal persons have no "ability to pay" in the sense of forgoing consumption or savings. There is, in other words, no conceptual basis for applying a progressive rate scale to companies.

Of the 11,418 incorporated taxpayers that were liable for CIT in 2002, only 150 derived income that crossed into the 40% bracket. GDNT officials know that one

reason for is income splitting between related entities. A key feature of any income tax that uses thresholds is the use of anti-splitting rules to amalgamate the incomes of related entities for the purpose of determining when a threshold has been crossed. The Mongolian CIT Law has no anti-avoidance measures and it has no provisions to prevent splitting in this way. As a result, although tax officials are aware that many or most small or medium enterprises use entity splitting to avoid the higher tax rate, they are unable to take any action to stop the practice.

The 150 corporate taxpayers that do pay tax at the 40% rate pay an average of 280 million tugrugs (US \$251,000) of tax at the 40% rate. Replacement of the progressive rate scale for corporations with a single rate would be desirable. As noted earlier, it is not possible to devise a revenue neutral rate for the CIT without calculating the effect of other changes recommended in this report. However, the current 40% rate collects substantial revenue. If nothing else were changed in the income tax system, the CIT revenue raised by current 15%/40% rate scale could be replicated with a flat rate of 36.7%. This rate might be appropriate for medium sized enterprises that have split income between related entities to pay tax at 15% but it would be a substantial increase for genuinely small entrepreneurs operating through corporate form. A single rate significantly lower than 36.7% might be possible if rate reform were adopted in the context of base broadening reform.

Recommendation:

The CIT progressive rate scale should be replaced with a single rate, to be determined after decisions on other recommendations in this report are finalized.

At present, the government is considering a proposal to maintain the progressive rate scale for companies but to reduce the top rate from 40% to 30%. In the absence of any other change, this would yield a drop in revenue of 9.7 billion tugrugs (US \$8.4 million) or more than 20% of company tax collections or 13% of all income tax revenues. The loss of tax revenue might not be this large if reduced commodity prices would have otherwise reduced profits and consequent tax revenues in the absence of a rate change.

It should be noted that at least one previous study has recommended retaining the progressive rate scale for corporations to prevent an increase in the burden of tax for small enterprises.⁸ A progressive rate scale is only feasible if the law contains comprehensive anti-splitting rules that are rigorously enforced by a strong tax administration. The GDNT has very limited capability at present to enforce such rules and is unlikely to acquire further skills in this area in the immediate to medium term. A single rate is thus desirable from both a theoretical and practical administrative perspective. The question of tax relief for small enterprises should be addressed through base broadening to achieve a lower uniform rate. However, if the progressive rate structure is retained, anti-splitting rules are needed to protect the integrity of the progressive rate scale.

⁸ Mann Report, p. 6.

Recommendation:

If a progressive CIT rate scale is retained, consolidation rules should be adopted to combine the taxable income of “group companies” before applying the rate scale. Group companies should be defined as all companies subject to the same ultimate beneficial ownership of at least 50% of the shares in companies (without regard to how many interposed entities may lie between the entities and the ultimate physical person owners).

II. Tax Concessions

1. Controlling tax concessions, including tax holidays

The CIT law contains a wide range of tax holidays and concessions that seriously distort investment patterns and undermine the revenue base. The concessions have virtually no safeguards or anti-avoidance design features and through restructuring, the use of interposed entities, transfer pricing between commonly owned entities, and asset sales between related entities, they may easily be exploited time and again by both domestic and foreign enterprises.

The Mongolian government is well aware from a range of reports and advice previously received of the serious fiscal and economic harm the tax concessions do. The government presumably also understands from the advice it has received from both international organizations and studies prepared for the private sector that tax concessions do not lead to investment. Studies consistently show that tax is one of the last determinants on the decision to invest and ranks far below more important factors such as political stability, labour costs, infrastructure, access to market, etc.

This Report will not repeat the advice of which the Mongolian government is presumably already well aware -- a broad base and lower rate will be more effective at fostering economic growth while a narrow base, higher rates and reduced number of taxpayers will inhibit long-term economic growth. Instead, the Report seeks to identify the factors that have led to what is by any measure a terribly excessive proliferation of inefficient, ineffective, and very costly concessions by a government that should be aware of the fiscal and economic harm of the concessions. Unless the problem is addressed soon, the long-term harmful consequences will be significant. Concessions remain and new concessions emerge at the same time other countries are successfully reigning in similar features in favour of broader bases and lower rates. If it does not act soon, Mongolia will face serious constraints competing with neighbouring jurisdictions as they move to corral concessions in favour of a broader base, lower rates and resulting economic neutrality and equity between taxpayers.

The fact that distorting and costly tax concessions are maintained and new ones are adopted reveals serious shortcomings in the Mongolian budgetary and tax design processes. The initial and most fundamental problem is a complete failure to cost tax concessions or to account for them in the budgetary process. This failure means that there is no transparency in the distribution of concessions, that accurate tax

expenditure accounting is impossible, and objective analysis of the measures is completely avoided.

Since the mid-1970s, modern public finance systems have treated tax concessions as “tax expenditures”. The object of the tax system is to transfer a portion of economic gains (income) realized by taxpayers from the taxpayers to the state for the state to apply to public purposes. The tax expenditure concept accepts as a fundamental premise that barring market failure, maximum economic growth will accrue in a market economy if investment and consumption decisions are made in the market rather than directed by government. Directed by government includes mandating or prescribing certain behaviour or biasing investment decisions by means of subsidies.

Starting with this premise, public finance measures the “benchmark” tax base as the base that would result in similar taxation of all economic gains (i.e., the most economically efficient base that freely permits market-based investment decisions). Deviations from the base in the form of concessions, holidays, and so forth, are then considered as the equivalent of applying the benchmark income tax and refunding the tax directly to beneficiaries of the concessions. In other words, the public finance tax expenditure analysis treats the concessions as the equivalent of expenditures to the beneficiaries of the concessions and accurately measures the cost of each “tax expenditure” against the benchmark income tax base.

In the last quarter of the 20th century, the tax expenditure budget emerged as one of the most effective public finance tools in the design of efficient tax systems. Starting with an economically efficient benchmark tax base, tax expenditures can be costed and analysed in the same manner as all other government expenditure programs. Tax expenditure analysis asks the same questions of tax concessions as are asked of direct expenditure and subsidy programs plus some specific to tax concessions:

- is there a market failure that requires subsidy or interference by the government?
- is the proposed subsidy the appropriate amount to spend to address the market failure?
- are the proposed beneficiaries the most appropriate recipients of the subsidy?
- if the answer to each of these questions is yes, should the subsidy be delivered through the tax system instead of by way of direct expenditures? and
- if the answer to this last question is yes, should the subsidy be delivered via deductions, exemptions, accelerated recognition of expenses or deferred recognition of income, tax credits, refundable tax credits, disappearing tax credits, tax holidays, etc.

Mongolia has no tax expenditure budget and the agency responsible for administering tax expenditures has no idea of the costs of the expenditures. The strong and apparent continued commitment of many Ministers to the continued use of tax expenditures appears to reflect a strong socialist background and an assumption that the market economy will not yield optimal economic growth unless the government intervenes by way of tax subsidies to bias investment into particular sectors. For the most part, the bias is away from the service sectors towards a limited range of heavy industry and infrastructure projects as well as mineral and commodities production. Some of these include sectors that are commonly thought to require no tax subsidies because investment is predicated on the presence of resources, not subsidies.

Reform of the tax law or budget system cannot address the underlying cause of tax concessions, Ministerial scepticism of the free market's ability to deliver maximum economic growth and Ministerial belief in the benefits of government distortion of investment decision-making by introducing biases to direct investment to the sectors nominated by the government. The initial step to reform is thus an extra-legal one, namely fostering support for a market economy in preference to socialist-style biases in the market.

In terms of legal structures, the costing of tax expenditures should be a specifically mandated responsibility of the fiscal analysis branch of the GDNT while the budget process should require both transparent analysis and reporting of tax expenditures and an "envelope" budgeting system that ensures benefiting Ministries bear the cost of tax expenditures directed at their portfolio. Direct fiscal accountability in this manner will help induce more responsible consideration of the consequences of tax expenditures by affected Ministries.

Recommendations:

1. The General Taxation Law of Mongolia be amended to require the GDNT to assess companies whether or not they enjoy tax holidays to determine what their income would have been but for tax holidays or similar concessions and to fully cost all concessions using conventional tax expenditure costing techniques.
2. The Budget Law be amended to require the Minister of Finance to produce a tax expenditure budget to supplement the current annual budget, providing details of the cost of and rationale for all identified tax expenditures.
3. The Budget Law be amended so the cost of tax expenditures is explicitly included in the notional allocation of resources to Ministries.
4. No new tax expenditures be implemented unless the anticipated costs are fully recovered through a legislated increase in tax rates or by means of a compensating reduction in the direct expenditure budget of the Ministry to which the tax expenditure is allocated.

2. Design of tax concessions

The tax concessions currently in the CIT law are highly distortionary and strikingly inefficient. Because they are poorly targeted, they can easily be exploited time and again by taxpayers engaged in enterprises different from the notional intended beneficiaries and, in the case of locational concessions, by persons in other locations. The absence anti-avoidance rules based on beneficial ownership tracing and non-arm's length transactions between associated persons means almost all the concessions can be easily abused. Foreign tax experts studying the Mongolian tax system are often bewildered as to how any tax at all is collected from the corporate sector given the ease with which existing enterprises could be shifted into enterprises qualifying for complete tax holidays. The most likely answer is a lack of

sophisticated tax planning advice but it must be presumed this will follow on the heels of continued generous concessions.

The most effective tax regime in terms of attracting foreign and domestic investment is one that has a low rate applying to a broad and stable base. “Concessions” over and above a stable and sustainable tax regime will not attract further investment or create employment. However, if concessions are a political imperative for domestic political reasons, the most efficient concession is an accelerated depreciation regime that applies equally to all sectors and all classes of taxpayers (incorporated and unincorporated, resident and non-resident).

More important are effective loss carry-forward rules. One reason for the ineffectiveness of the current tax concessions is they apply during the initial start-up period of companies when losses are most likely to be incurred. In the case of large infrastructure projects or mining enterprises, loss years are likely to extend for a considerable period and tax holidays are of no real value. In practice, tax holidays are most likely to be exploited by existing businesses that transfer income-generating activities and assets to new enterprises to exploit the concessions. Thus, the concessions cannot generate new investment but can remove the tax burden from existing businesses.

The adoption of loss carry-forward rules has been identified as a priority need for Mongolia.⁹ If adopted as part of an overall corporate tax reform, loss carry-forward rules, in combination with a slightly accelerated depreciation regime, could replace all current concessions.

It has been suggested in a previous report that a five year carry-forward provision would be desirable.¹⁰ If loss carry-forward is used to wind back tax holidays and similar concessions, a slightly more generous rule could be adopted. A seven year carry-forward period would be of more use to very large infrastructure and mining projects.

Recommendation:

A seven year loss carry-forward rule be adopted for all taxpayers. Safeguards include continuity of business type or continuity of ownership should be added to prevent sales of loss companies.

3. Stabilization agreements

In all democratic market economies, minor changes to tax rules and occasional larger reform programs are an inherent feature of the investment environment and taxpayers do not seek or obtain stabilization agreements to preserve tax rules in effect at the time an initial investment is made.

⁹ See, for example, Mann Report, p. 10.

¹⁰ Mann Report, p. *.

Stabilization agreements may be sought, however, in emerging economies which have adopted clearly unsustainable tax rules that must give way to a more realistic regime when the pressures of deficit finance become untenable. Under authorization in the Foreign Investment Law, the GDNT has entered into stabilization agreements with a number of investors.

If Mongolia reforms its CIT to adopt a sustainable base and rate with a uniform accelerated depreciation regime, the need for stabilization agreements will disappear and the existing rule can be capped at that time.

4. Minimum Income Tax

A backstop against revenue leakage through excessive tax concessions is a minimum income tax. An “alternative” minimum income tax (creditable against the ordinary income tax) has been used in a limited number of advanced market economies where it played a more important role prior to base broadening reforms of the 1980s and a true minimum income tax remains important in some emerging economies, particularly those with weak tax administrations. It has been suggested that a minimum income tax based on turnover or gross assets may be useful in Mongolia.

While the minimum income tax can be used as a means of clawing back the effect of tax concessions, it is not a recommended option. The minimum income tax, particularly if it is based on gross assets, applies in a very uneven fashion, having no effect on highly profitable service industries with few, if any, fixed assets, and imposing an unfair positive tax rate on large enterprises with significant infrastructure investments that are likely to be in real loss positions for several years. More importantly, unless an exemption were adopted for foreign-owned enterprises, the tax would discourage foreign investment because it would most likely not be treated as a creditable tax for foreign tax credit purposes. An exemption for foreign-owned enterprises would be problematic in the case of enterprises with both foreign and domestic investment and it would encourage domestic firms to re-route investment through offshore subsidiaries.

The minimum income tax should be reconsidered as an option only if efforts to broaden the tax base and reduce the CIT rate are not successful.

PART B

TECHNICAL REFORM ISSUES

III. The CIT tax base and rate structure

1. Charging provision and general structure

Central to the operation of all tax laws is the “charging provision” that actually imposes a liability to pay tax. The charging provision ties together the key conditions for a tax liability – tax is imposed on taxable income derived by a taxpayer in the income year. Each of these terms is subsequently defined – taxable income is gross income less deductions allowed in the computation of taxable income; a taxpayer is defined as a company or entities deemed to be a company, and the tax year fixes the period for annual calculations. Some of these terms are defined in turn. For example, gross income is usually defined as world-wide income for resident taxpayers and domestic-source income only for non-resident taxpayers.

The Mongolian CIT contains no general charging provision and has no basis for the ordinary progression of definitions and sub-definitions to give effect to the charging provision. The structure of the law, adopted in 1993 shortly after the move to a market economy commenced, reflected the authors’ limited understanding of tax conventions. The result is considerable confusion both among taxpayers and tax officials on how the pieces of the tax puzzle fit together. The definition of “taxable income” in Article 4 actually applies to gross income. The definition of “taxable income” in Article 5 is actually a listing of deductions allowed in the computation of taxable income. The rate schedule set out in Article 6 applies to both gross income and taxable income, with no indication in the law as to which type of income is subject to which rates. The rate schedule also imposes tax as a charging provision in one case.¹¹

The initial structure of the CIT has remained in effect from the origin of the law. It is ill-suited to the development of a CIT appropriate for Mongolia’s developing economy.

Recommendation:

The CIT should be amended to achieve a format and structure consistent with modern CIT laws. It is suggested below that the law be redrafted in the context of a tax code for Mongolia or, failing adoption of a code, that it be redrafted into a modern format. If these recommendations are not adopted, the current law should be amended to align its structure with conventional modern tax law structures as described above.

¹¹ This is the “branch profits tax” imposed by Article 6, paragraph 3.

2. Entities to which the law applies

Because the PIT law only applies to physical persons, it is important that the CIT contain a comprehensive definition of entities subject to that law to ensure all entities or arrangements apart from physical persons fall under the CIT. The current definition suffers from serious shortcomings. It is based on socialist-style classifications from an era when it was possible to categorise economic arrangements because all arrangements had to conform with state guidelines. A key feature of a market economy is the flexibility to adopt any type of legal form and any type of legal arrangement to achieve identical economic outcomes.

The current list of entities subject to the tax is far from comprehensive and some of the terms it adopts are based on socialist terminology and concepts for arrangements that are inappropriate for market economies. For example, it adopts the socialist concept of a “joint venture” as a separate entity while in market economies that term is used to describe an economic arrangement that is deliberately structured to ensure there is no separate entity or partnership created.

Recommendations:

1. The CIT should adopt a comprehensive definition of legal persons and other economic or legal structures (e.g., partnerships, trusts, governments) to which the law applies. In particular flow-through entities not known to Mongolian law such as common law partnerships or trusts should be defined to be companies for the purpose of the CIT. For example, the definition could be expanded to include “entities, legal relationships including trusts, partnerships, and any other a body or association of persons incorporated or unincorporated deriving income through investment or business”.
2. Rather than use different terms inconsistently, the law should refer to “companies” in Article 3, paragraph 1, subparagraph 1 and a new subparagraph should be added to deem other entities to be companies for the purpose of the Act. References to different types of entities throughout the Act could then be replaced with the term “company” where appropriate to automatically pick up other entities or relationships. For example, the current definition of taxpayer includes non-residents “legal entities”, a concept that would exclude non-resident trusts and partnerships from common law jurisdictions. If the broad definition of company is adopted, the term “legal entities” in Article 3, paragraph 1, subparagraphs 6 to 8 can be replaced with “companies” and those three subparagraphs will extend to all other entities and relationships treated as companies.

IV. International tax issues

1. Residents and non-residents

With only a few exceptions, most contemporary tax systems distinguish between resident and non-resident taxpayers, with the former assessable on their world-wide income and the latter only on their income that has a source in the jurisdiction.

The Mongolian CIT deviates from the norm. The law provides separate tax rates (Article 7) for “resident” taxpayers and “non-resident” taxpayers but there is no definition in the law itself to distinguish between resident and non-residents. A definition is provided in the regulations¹² but it is somewhat obscure and authorities have difficulty applying it in practice in many instances.

Recommendation:

The CIT should contain a definition of a “resident” and a “non-resident” taxpayer. The definition can be based on the definition used in Mongolia’s double tax agreements. It is suggested it include companies incorporated in Mongolia, companies whose central management and control is in Mongolia, and perhaps companies that carry on business in Mongolia if a majority of the shares with voting power are owned by residents of Mongolia.

2. Tax base in terms of “source” for residents and non-resident companies

The CIT rules applying to non-residents are not clear and tax officials reported a wide range of interpretation of the rules. Non-resident companies are defined to be taxpayers in two provisions – one makes non-resident companies generally taxpayers¹³ and the other makes non-resident companies that operate through a representative office taxpayers.¹⁴ The two provisions are not coordinated and tax officials are not sure how they interact with one another – can the same taxpayer be a taxpayer under both sections, once in respect of its income generally and again in respect of its representative office income?

The confusion is compounded significantly when the Articles defining the tax base and rates for taxpayers are considered. Where a taxpayer operates through a representative office, only its Mongolian-source income is subject to tax.¹⁵ No similar restriction applies to non-resident companies that do not operate through a representative office. They are prima facie assessable in Mongolia on their worldwide income even though the non-Mongolian source income has no connection with Mongolia. This interpretation is reinforced by the fact that assessable income is restricted to Mongolian income for companies with representative offices; by

¹² The legal effect of the definition in the regulations is not entirely clear since there is no delegation power in the law to determine this issue by way of regulation. As a general rule, regulations may give effect to provisions in the law itself but may not impose taxation or provide reliefs unless the law specifically authorises this. This is because the law is reviewed by the parliament while regulations are issued by the executive. In socialist economies it is quite common for substantive tax law to be issued by way of executive or administrative “circulars” or regulations. However, governments move towards conventional democratic norms, it is common for the executive to lose its law-making powers to the parliament and then be regranted delegated powers by way of statute passed by the parliament.

¹³ Article 3, paragraph 1, subparagraph 7.

¹⁴ Article 3, paragraph 1, subparagraph 2, applying to “representative office”, defined in Article 2, paragraph 2. The definition is similar to that commonly used for “permanent establishment” in international tax law.

¹⁵ Article 4, paragraph 2.

implication the failure to provide a similar rule for other non-resident companies could mean that no similar restriction applies to them.

Recommendations:

1. The provision including non-resident companies in the CIT should be modified to make it clear that the inclusion is only in respect of their Mongolian-source income. Specifically, Article 3, paragraph 1, subparagraph 7 should be modified by adding the words “in respect of their Mongolian-source income” at the end of the subparagraph. Alternatively, the definition of gross income can be modified to ensure it includes only Mongolian-source income for non-resident taxpayers.
2. Where a non-resident company operates through a representative office in Mongolia, that office should be treated as if it were a separate entity resident in Mongolia. This would mean a non-resident would be taxed separately in respect of income derived through its representative office in Mongolia and in respect of income derived directly by the head office outside Mongolia. Specifically, a new paragraph should be added to Article 3 to make it clear that a representative office (i.e., permanent establishment, as discussed below) will be treated as if it were a company separate from the non-resident company to which it belongs for the purposes of the CIT law.
3. To clarify the tax position of companies that derive income both through a representative office and directly, the paragraph that makes non-resident companies taxpayers should be modified so it is clear that non-resident companies with representatives offices are taxed separately in respect of income derived other than through the permanent establishment. Specifically, Article 3, paragraph 7, should be modified to make it clear that it applies in respect of income other than income that is treated as income of a permanent establishment in Mongolia of the taxpayer. As explained below, under the “force of attraction” principle, income of a permanent establishment may include some income derived by non-resident head office in some cases.

3. Representative offices and permanent establishments

The term “representative office” derives from socialist era tax concepts. The actual definition of a representative office is similar to the definition of a “permanent establishment” in Mongolia’s international tax treaties. Retention of the term “representative office” causes some confusion as the term has a fundamentally different meaning in tax law. The term “permanent establishment” should be substituted for “representative office”.

Recommendation:

The term “representative office” in Article 3, paragraph 1, subparagraph 2 and in Article 3, paragraph 2 should be replaced with the term “permanent establishment”.

4. Clarification of rates

The CIT sets tax rates for non-resident taxpayers.¹⁶ Resident taxpayers are subject to a progressive rate scale (15% and 40%). Non-resident taxpayers other than those operating a permanent establishment are subject to the same progressive rates on some income and to a flat 20% rate on other income. The 20% rate applicable to non-residents applies to Mongolian-source income only. The progressive rate structure was probably also intended only to apply to Mongolian-source income of non-residents, though, as noted earlier, the law does not make this clear. It seems the progressive rate structure was intended to apply to taxable income (i.e., net of expenses) while the 20% rate was intended to apply to gross income. The relationship between the rates and bases is not clear and tax officials appear to not understand how the rules should operate in practice. There is, for example, some confusion as to the tax rate applicable to business income derived by non-resident companies (it is assumed by many that the 20% rate applies when in fact the 15%/40% progressive rate applies to this income). The confusion is compounded where taxpayers incur expenses to derive income generally, some of which is subject to the 20% tax rate and some of which is subject to the progressive rate scale. It would be very difficult to address these serious shortcomings without adopting a conventional CIT structure such as that described in Section III, 1, above. If a conventional charging provision and primary provisions are adopted, the base for residents and non-residents should be clarified.

Recommendations:

1. The distinction between gross income and taxable income as different bases for non-residents should be clarified.
2. The apportionment of expenses incurred by taxpayers that derive income subject taxation under the gross income provisions and income that is included in the calculation of taxable income.

5. Non-residents that operate through a permanent establishment

A permanent establishment is a “branch” of a foreign taxpayer. Tax systems commonly treat permanent establishments as separate taxpayers, distinct from the entity to which they belong. The permanent establishment may be taxed on local-source income only or may be taxed on income from world-wide sources. There is often little difference in practice between the two approaches since foreign enterprises will rarely route through a foreign branch overseas income that could be derived directly by the head office.

Commonly, permanent establishments are treated as local enterprises and taxed at the same rates as local companies. This usually means they will be subject to higher tax rates than would be the case if they were treated as a non-resident taxpayer in respect of particular types of income such as interest income, royalties or dividends. Thus,

¹⁶ Article 6, paragraph 1, subparagraph 7.

for example, non-residents deriving Mongolian source income of these sorts are usually taxed at 20% on this income while resident companies may be taxed at up to 40% on the same types of income. If permanent establishments are not taxed in the same manner as local companies, non-residents that operate through permanent establishments would enjoy a significant advantage over local competitors.

The adoption of a separate definition for a permanent establishment¹⁷ was presumably intended to ensure that permanent establishments in Mongolia were subject to tax in the same manner as resident taxpayers. The law does not achieve this objective, however, since a permanent establishment is still a non-resident as it is legally simply a branch of a foreign taxpayer.

Recommendation:

The law should make it clear that a permanent establishment will be treated as a distinct taxpayer separate from the foreign head office and will be treated as a resident company so it is subject to tax in the same manner as other resident companies. In the case of a permanent establishment of a physical person, the permanent establishment could also be treated as a separate company for Mongolian tax purposes.

Because branches can operate in a variety of forms, it is important for the law to contain a comprehensive definition of a permanent establishment. This approach has been adopted in many of Mongolia's double tax agreements with foreign governments but it is not used in the tax law. Instead, the definition of permanent establishment in the CIT law is limited to four types of branches.

Recommendation:

A broader definition of permanent establishment should be adopted, consistent with the definition used in Mongolia's international tax treaties, and including the UN model treaty rules that apply to businesses operating in the country through employees or consultants without necessarily having a fixed place of business.

Because a permanent establishment is merely part of a larger foreign entity, its income and its expenses are integrated with those of the larger entity. If the permanent establishment is to be taxed as if it were a separate taxpayer, rules are needed to deal with recognition or non-recognition, as appropriate, of payments between other parts of the company and the permanent establishment and vice-versa. Similarly, rules are needed to apportion expenses borne by the head office and income derived by the head office where some of the expenses or income is attributable to the permanent establishment.

Recommendation:

The law should provide comprehensive rules explaining how the taxable income of a permanent establishment is calculated. In particular:

¹⁷ Article 3, paragraph 2.

- (1) Subject to the proviso in paragraph (2) below, no deduction should be allowed for amounts payable by the permanent establishment to its head office or to another permanent establishment of the non-resident person as -
 - (a) royalties, fees, or other similar payments for the use of any tangible or intangible asset;
 - (b) compensation for any services, including management services, performed for the permanent establishment; or
 - (c) interest on moneys lent to the permanent establishment, except in connection with a banking business.
- (2) A permanent establishment should be allowed a deduction for an amount payable as a reimbursement of actual expenses incurred by the non-resident person to third parties if the reimbursement is otherwise deductible under this Act.
- (3) Amounts deductible as a result of paragraph (2) above, should be included in the definition of Mongolian-source income.

If a permanent establishment is treated as a separate entity distinct from the head office to which it belongs, the head office can derive income separately from the branch. Because some income derived by non-residents is taxed at a lower tax rate than the rate that would be applicable to a permanent establishment, there is an incentive to divert income directly to the head office rather than derive it through the permanent establishment. Also, if the branch profits tax is applied (as discussed in paragraph 7, below), income earned through the permanent establishment will be taxed twice while income earned directly by the head office will be taxed once. This creates another incentive to divert income from the branch to be derived directly by the head office (or another part of the company located outside Mongolia).

To address this problem, the UN model tax treaty adopts a concept known as the “force of attraction” principle. Under this principle, any Mongolian-source income derived by a part of the company other than the permanent establishment will be treated as income derived by the permanent establishment if it relates to the operations of the permanent establishment or is of the same character as income derived by the permanent establishment or it relates to goods or services provided by the company that are similar to the goods or services provided by the permanent establishment.

Recommendation:

The rules defining the income attributable to a permanent establishment should incorporate the UN model treaty’s “force of attraction” principle.

6. Source rules

Under the current law, non-resident companies that operate through a permanent establishment are assessed only on their income “derived from sources in Mongolia”.¹⁸ It was the apparent intention of the drafters that other non-resident companies should also be taxed in Mongolia only on their Mongolian-source income, although the law was not drafted this way and as it stands such persons are liable for tax in Mongolia on their world-wide income.

Because the law contains no source rules, it is difficult to impossible to enforce the law as it is written for permanent establishments and intended to operate for other non-resident companies. In the absence of comprehensive source rules and administrative guidelines and procedures for enforcing the law, there is a sharp dichotomy between the GDNT head office, which asserts the theoretical power of the GDNT to assess non-resident companies on Mongolian-source income, and practice in the field, where there are serious gaps in collection of tax on much Mongolian-source income. While it is beyond the scope of this Report to consider the issue in terms of physical persons, the problem is equally acute in respect of non-resident physical persons such as, for example, the author of this Report who should be liable to Mongolian tax.

The first step collection of tax from non-residents is a clear definition of Mongolian-source income. This can be used as the basis for developing comprehensive tax collection rules and procedures.

Recommendation:

The law should provide comprehensive source rules explaining when different types of income from investment and property, including capital gains from the disposal of tangible or intangible property, are Mongolian-source income and when income from business and employment will be Mongolian-source income.

7. Branch profits tax

Under the classical company and shareholder tax system used in Mongolia (see section V, 1, below), profits are taxed when earned by a company and after-tax distributed earnings are taxed again as dividends or deemed dividends when distributed to physical persons or to non-residents.¹⁹ In the absence of any further measures, non-residents that operate in Mongolia via a permanent establishment (a branch of the foreign company) could enjoy significant tax savings compared to competitors that established separate subsidiaries in Mongolia. The former would be subject to one level of Mongolian tax only, while the latter would be subject to tax at

¹⁸ Article 4, paragraph 2.

¹⁹ As noted below, under current Mongolian law distributed earnings are also taxed each time they move within a domestic company group. However, this Report recommends that system be altered to avoid compounding taxes on profits moving through a group, a system that may inhibit taxpayers from adopting optimal corporate ownership structures.

the Mongolian company level and again when profits are distributed as dividends to the foreign company that is the shareholder of the Mongolian company.

To avoid this disparity, many countries impose a “branch profits tax” on branches of foreign companies that approximates the tax which would be imposed on dividends from a separate subsidiary flowing to any overseas shareholder. The Mongolian CIT contains a provision that is intended to act as a branch profits tax, imposing a 20% tax on “income” that is transferred abroad.²⁰

It is not clear that tax assessors are applying this section. The ambiguous language of the provision makes it difficult to develop workable assessment guidelines and procedures for tax officers in the field. An initial problem is that the provision is a paragraph in the Article that sets tax rates on different types of income. Unlike the other paragraphs in this Article, the branch profits Article is a charging provision that imposes a tax liability, defines the base to which the liability attaches, describes the taxpayer liable for the tax, and includes the rate of the tax. This structure fits very awkwardly in the structure of the CIT law more generally.

A further problem is the definition of the tax base – “income” of the branch. Income of the taxpayer was taken into account when determining its taxable income (i.e., income less deductions allowed) and the amount remaining to the taxpayer is the after-tax taxable income, a two-step removed subsidiary part of the original gross “income” derived by the taxpayer.

A difficulty encountered with all branch profits taxes is when to impose the tax. No such timing difficulties are encountered with subsidiaries as the declaration and payment of a dividend involves a discernible transfer from one legal person to another. In the case of a branch or permanent establishment, the branch is merely an arm of the head office and the movement of funds between the head office and branch or vice versa is simply an internal accounting procedure – the assets of the branch, including the retained after-tax profits, are always the property of the foreign head office as a matter of law since the local branch is not legally a separate person.

One solution used in some jurisdictions is to impose the branch profits tax at the same time the primary income tax is imposed, with the branch profits tax imposed on annual after-tax profits. This approach solves the technical problem of determining when profits are repatriated but it introduces a new bias in favour of operating through a subsidiary since companies that operate through subsidiaries can defer the second level of tax until dividends are paid to the parent company. This bias is a deliberate policy outcome in some jurisdictions that have adopted this approach.

A more neutral approach can be used in jurisdictions that treat branches as if they are separate entities (as is recommended in this Report that Mongolia do). If this approach is taken to taxing branches, it will be possible to notionally isolate the accounts of Mongolian branches and to define events that will constitute the equivalent of a dividend. Transference of profits from a branch to a head office does not have to take the form of a physical transfer of money, as anticipated by the current provision. For example, a branch could simply use its funds to acquire an asset which

²⁰ Article 6, paragraph 3.

by definition belongs to the head office. Thus, the rules for determining income to which the branch profits tax will apply should focus on transferences of value from the branch rather than physical flows of funds. For example, if the rules treat branches as separate entities, it can be determined whether applications of branch funds result in acquisitions that are recorded as assets of the branch or as assets of the head office, with the latter being treated as a distribution subject to branch profits tax.

8. Withholding taxes

As discussed elsewhere in this Report, it was probably intended by the drafters of the CIT that certain types of Mongolian-source income derived by non-resident companies should be subject to flat rate taxes imposed on gross income. Some shortcomings in the law that prevent this from being fully achieved include the absence of a definition of non-resident companies, the absence of source rules, and the absence of a rule that makes it clear the tax rate applies to gross income rather than net profits. Nevertheless, as noted previously, the concept of flat rate taxes imposed on particular types of gross income derived by non-residents is sound and consistent with international norms. Normally, these taxes would be collected by way of withholding taxes, meaning the person paying the income, and not the non-resident recipient, is responsible for remitting the tax.

A comprehensive withholding tax system applicable to the four types of income subject to the flat rate 20% tax should be adopted. Complementary changes to other provisions should be enacted to protect the integrity of the withholding tax system.

Recommendation:

The tax on income subject to the 20% rate imposed on gross income should be collected by means of a withholding tax regime. Withholding tax provisions should include:

- rules to relieve the recipient of income of tax where tax has been withheld as required,
- penalties for non-withholding where required
- denial of deductions for payments from which tax should have been withheld but was not; and
- details of the payment procedures for withheld taxes

9. Transfer pricing

Transfer pricing commonly occurs between parts of an international organization as profits are shifted from a higher tax jurisdiction to a lower tax jurisdiction by means of an inflated or deflated “transfer price” for goods or services provided by one entity within a group to another entity in a separate country. Because it has different effective tax rates throughout the country as a result of the generous tax holiday concessions for investment in peripheral areas, Mongolia also experiences transfer pricing within the country to shift profits between entities. Thus, Mongolia requires rules preventing abusive transfer pricing for domestic and international transactions. It is possible to legislate a simple rule mandating “arm’s length” pricing in all

transactions between related parties, broadly defined, and to provide more complex rules on how to calculate arm's length prices in different types of transactions in regulations or rulings.

Recommendation:

The law should allow the GDNT to substitute arm's length pricing between unrelated parties whenever a transaction between related parties is carried out at a different price.

10. Foreign tax credits

The CIT imposes tax on the world-wide income of Mongolian resident taxpayers. Where income is sourced from outside Mongolia, it may be subject to tax in the country of source. To prevent double taxation of such income, the Mongolian income tax should provide credit for foreign taxes imposed on foreign-source income.

Recommendation:

A foreign tax credit regime should be adopted to provide resident taxpayers with credits against Mongolian tax for foreign taxes imposed on foreign-source income. The credit system should provide strict quarantine rules to prevent abuse of the credit system by shifting of income types or shifting of income from different jurisdictions.

11. Treaty policy

Mongolia is party to 33 tax treaties. Its treaties generally follow the format and contents of the OECD model treaty. However, in many respects its treaties follow the format of the UN model treaty. The OECD treaty favours capital exporting nations by severely limiting the taxing powers of source (i.e., capital importing) countries while the UN treaty tends to shift taxing rights back to source countries.

The OECD and UN treaties are subject to regular revisions and treaty practice evolves continually. It is, therefore, important that Mongolia's treaties not be considered static agreements. Rather, they should be subject to continuous critical review and updated through negotiated protocols or replacement treaties when appropriate.

Given the fundamental importance of Mongolia's tax treaties in terms of establishing Mongolia's taxing rights over income sourced in the country, the regular critical review of the treaties should be undertaken by a committee comprising international tax experts in the GDNT Division of Tax Administration and Methodology, at least one tax inspector in the collection division with experience assessing taxpayers subject to treaty protection, and representatives from the tax policy division of the Ministry of Finance.

It is also important that a pool of experts in international treaty negotiation be built up in the GDNT to allow for an orderly transition of treaty negotiating responsibilities when the expert currently responsible is unavailable for the task.

Recommendations:

1. A committee be established to regularly review Mongolia's international tax treaties in light of experience applying the treaties in Mongolia and changes to international treaty practice.
2. Steps be taken immediately to provide comprehensive training on international tax treaty theory and practice, as well as fundamentals of international tax treaty negotiation, to suitable officers in the GDNT who will be able to assume negotiation responsibilities as required in the future.

V. Company finance

1. Intra-group distributions

Mongolia has adopted what is commonly called a "classical" company and shareholder tax regime under which companies are taxed separately from shareholders and distributions of taxed company profits are treated as new income of shareholders, without recognition of the fact that the income has been previously taxed.

An alternative company and shareholder tax system model is known as the "imputation" or "partial imputation" model that seeks to partially integrate the company and shareholder tax regimes by providing shareholders with some relief from taxation when they receive income that has already been taxed at the company level.

The classical system used in Mongolia is common in countries at the level of economic development of Mongolia and is more compatible with the international tax system so it is recommended that this system be retained.

Under the pure classical tax system model, income is taxed when derived by a company and again when it is distributed to a physical person or to a non-resident (whether physical person or legal person). Normally, the law provides relief from taxation where income flows through more than one company between its first derivation and its distribution to a physical person or a non-resident. For this reason, it is common to provide an exemption or similar relief for inter-corporate dividends. If this is not provided, there will be compounding tax liabilities as profits move through related companies. This will greatly distort commercial decisions on how to structure corporate businesses and may lead to inefficient business structures.

The CIT does not provide relief on intercorporate dividends. As a result, profits derived through potentially efficient corporate structures may suffer unreasonable tax burdens. Consider, for example, the case where a group of physical persons establish a holding company that in turn acquires a range of operating companies, one of which

has a subsidiary. If the subsidiary derives 100 Tgs and distributes its after-tax profits, the operating company would receive a dividend of 60.²¹ It would bear a tax of 9 on the dividend it receives,²² leaving it with 51 to distribute to the holding company. The holding company would pay 7.65 tax and have 43.35 to distribute to the physical persons. They would pay 15% tax on the dividend received²³ (6.50) and have 36.85 after tax. In other words, the total tax levied on the profits between first derivation and final receipt by a physical person would be 63.15%. It is generally accepted in jurisdictions that use the classical company and shareholder tax system that there is justification for imposing separate taxes on companies and on physical person shareholders (and non-resident shareholders) but there is no basis for imposing tax as profits move through a corporate chain. The multiple taxation can lead to significant commercial distortions.

Recommendation:

The CIT should provide relief from compounding taxation where after-tax profits pass through a chain of companies either by way of an exemption for inter-corporate dividends (other than dividends paid to non-resident companies) or a tax credit for tax imposed on such dividends.

2. Dividends

The classical tax system imposes tax on distributions of company profits, conventionally called “dividends”. Conventional dividends are distributed to shareholders following a resolution by the company directors. Under company law, only “profits” can be distributed as dividends and profits are measured using accounting concepts, not tax law.

It is possible to distribute profits in other ways. Retained earnings may be capitalized and distributed to existing shareholders by way of a share dividend (a dividend comprising new shares).²⁴ Alternatively, they may be used to cancel shares on a pro-rata basis so the relative position of shareholders does not change but they receive what appears to be capital distributions rather than distributions of profits. Reductions of capital can be used to achieve the same result. Retained profits may also be distributed by way of an on market (in the case of listed companies) or off market (in the case of listed and unlisted companies) share buy back. Finally, distributed profits may be distributed indirectly by way of benefits for shareholders such as distributions in kind or provision of goods or services.

The current law treatment of indirect distributions through share buybacks, cancellation or liquidation is uncertain. The law speaks of the income of taxpayers²⁵ including dividends and “gains” on shares.²⁶ The language is ambiguous and could

²¹ After a 40% tax -- Article 6, paragraph 1, subparagraph 1.

²² Article 6, paragraph 1, subparagraph 2.

²³ PIT, Article 8, subparagraph 4.

²⁴ Known as “stock dividends” in US terminology or “bonus shares” in many other countries.

²⁵ The CIT refers to the “taxable” income of shareholders but presumably this is meant to be “gross” income – see Article 4.

²⁶ See CIT, Article 4, , paragraph 1, subparagraph 9.

include other distributions of profits such as those described above. But while it is the view of at least one GDNT official in the GDNT division responsible for tax drafting that this is the case, officers in the field do not appear to interpret it this way. It would in theory be possible to apply the law to catch these gains if comprehensive ordering rules (profit is received before returns of capital – discussed further below) and gain measurement rules were drafted in subsidiary regulations. In the absence of detailed rules, it must be presumed that virtually all taxpayers and most tax assessors will continue to disregard these indirect distributions.

Recommendations:

1. The CIT should contain a distributions ordering rule preventing distributions of capital before all retained earnings have been distributed (a distribution “ordering” rule).
2. A comprehensive definition of dividend should be adopted to include distributions of profits through off-market share buybacks, share cancellations, indirect provision of benefits, and liquidation distributions. Alternatively, if the current rule applying to “gains” is retained, comprehensive public rulings should be provided to explain how gains are calculated in each of these situations.

A common application of retained profits in market economies, particularly for widely-held shares, is to capitalize retained earnings and apply the amounts to the issue of new shares to shareholders on a pro-rata basis to their existing holdings.²⁷ If tax authorities had complete confidence in their ability to assess gains when the shareholder eventually sells the new shares, there is, in theory, no need to tax the capitalization at the time the shares are issued. In one sense, the capitalization of retained profits does not represent a “realization” of accrued gains. Rather, it is a merely legal reorganization of existing wealth. Thus, one approach, used in some countries, is for the law to deem a zero cost base for the new shares and tax the entire value of the sale proceeds as ordinary income when the shares are eventually sold. However, it is more common for tax laws to treat the capitalization as a realization of gain on the basis that the capitalization has resulted in a fundamental change in the legal character of the shareholders’ claim to the retained profits. Where this is done, the value of capitalized profits is treated as a dividend and this amount then becomes the cost base of the new shares for the purpose of measuring gain or loss on subsequent disposal.

Recommendation:

The definition of dividend should include capitalized retained earnings that give rise to new shares in a company, with corresponding rules to increase the cost base of the new shares by the amount taxed as a deemed dividend at the time of profit capitalization.

To avoid the tax on dividends, a company could provide retained earnings to shareholders by way of a “loan” that does not carry any interest charge (or which

²⁷ As noted above, sometimes known as a share dividend, stock dividend or bonus share.

carries a nominal interest charge). This is not likely to occur with a public company because other shareholders will protest at the loss of economic wealth diverted to the shareholder who has the no-interest or low interest loan. However, it is very likely to occur in the case of a private company where there are no outside shareholders who would be disadvantaged if company resources were made available by way of loan to the owner. Thus, it is common for company tax regimes to treat non-arm's length loans (loans for less than market value) as dividends. A complementary rule can provide an exemption for a subsequent dividend used to redeem or repay a loan that has been treated as a dividend.

Recommendation:

All loans by private companies to shareholders or associates of shareholders not bearing market rate interest and having a definite repayment schedule that is adhered to by the borrower should be treated as a dividend. A complementary rule should exempt from tax a subsequent dividend used to redeem the loan.

3. "Debt" dividends

If inter-corporate dividends are freed from compounding tax, financing companies may seek to recharacterise debt as equity investment. Commonly this is attempted with redeemable preference shares or similar instruments that can offer protection similar to that of debt while the returns to the lender are characterised as dividends. Anti-avoidance measures will be needed to deal with this possibility.

Recommendation:

If the tax on inter-corporate dividends flowing to resident companies is removed, anti-avoidance provisions should be drafted to ensure no tax-free flow through is available for dividend payments on equity arrangements that are equivalent to debt.

4. Thin capitalization

Under the classical tax system, profits are taxed when derived by a company and again when distributed to shareholders. (As noted earlier, it is common to exempt inter-company dividends so profits are taxed when first derived by a company and when distributed to a physical person.). If an investor finances a company by way of debt, the interest payments are deductible to the company and to they extent profits are used to make interest payments, they are subject to one level of tax only.

This phenomenon leads to "thin capitalization" arrangements whereby investors provide only a little equity capital and fund enterprises primarily through debt. To counter these arrangements, CIT laws commonly contain thin capitalization rules that prohibit deductions for interest on loans to related parties that exceed equity investments by a given amount.

The thin capitalization rule in the Mongolian CIT has been incorporated into the “Definition of Taxable Income” Article, which is actually the Article that sets out allowable deductions. The thin capitalization rule has been appended to a sentence that contains all the prohibitions on deductions and it prohibits deductions for interest on loans from “interdependent legal entities” to the extent the loans exceed 30% of the share capital of the borrower. This is the equivalent of a 1: 3.3: debt-equity ratio.

There is precedent for a 1:1 ratio debt-equity ratio but the lowest ratio normally used is 2:1 and the standard would be in the range of 3:1. In other words, the normal rule allows 9 times the debt allowed under the Mongolian rule. Previous advice to the Mongolian government suggested that a 2:1 debt-equity ratio might be a useful starting point for determining a thin capitalization rule.²⁸ While this ratio is used in some jurisdictions, as noted it is relatively low by international standards. It is suggested higher standard would be appropriate as a base ratio.

Previous advice also been noted that reasonable debt-equity ratios will vary from sector to sector. In a full market economy where enterprises can engage in multiple activities it is very difficult to classify businesses into particular sectors and the use of multiple ratios is difficult. An exception may be made for financial institutions subject to prudential regulation (i.e., banks and insurance companies) which must maintain separate functions to comply with prudential legislation.

The current rule applies to debt from “interdependent legal entities”, a term not defined in the legislation. Clarification is needed. Also, the rule should apply to unincorporated lenders as well.

Recommendations:

1. Consideration be given to adopting a 3:1 debt-equity ratio for non-financial institutions and a 6:1 ratio for financial institutions.
2. Relevant debt for purposes of the thin capitalization rule should be extended to debt from “associates”, broadly defined to include related physical persons and unincorporated entities deemed to be companies for Mongolian tax purposes such as common law partnerships or trusts.

5. Treatment of debt finance

Where a company is financed in part by debt from its owners or third parties, interest payments may be subject to a variety of income tax rates depending on the status of the lender:

- interest to non-resident corporate lenders is subject to a 20% tax rate, whether the lender is a financial institution or other business; while the law does not state this, it is the view of GDNT officials that the rate applies to gross interest;
- interest to resident corporate lenders that are banks is subject to a 15% tax rate; while the law does not state this, it is the view of GDNT officials that the

²⁸ Mann report, p. 12.

rate applies to gross interest (note: the official English version of the law published by the MTA has a 15% rate but it was the view of one responsible GDNT officer that the rate is 20% and the official version of the law is incorrect);

- interest to resident corporate lenders that are not banks is subject to a 15% tax rate or a 40% tax rate under the progressive income tax scale applied to corporations; while the law is not specific on this, it appears this rate applies to net interest income;
- interest to resident physical person lenders is subject to a 15% rate; the law is silent on this matter but it is the view of GDNT officials that the rate applies to net income.

There are a limited number of formal banks (under 15) operating in Mongolia, supplemented by a large number of other credit providers (about 350 credit-type companies) and formal debt financing is also available from companies that are not primarily credit providers. It is not clear whether the 15% rate on interest payable to a bank also extends to non-bank loan institutions,²⁹ but there can be no doubt that the proliferation of rates (and the consequent different rates of after-tax returns to different categories of lenders) must distort the lending market. In particular it inhibits non-bank corporate lenders, potentially restricting entrepreneurs access' to debt funding.

Alignment of the tax base (net or gross interest) and rates is important to achieve a level playing field for lenders and businesses seeking debt finance.

While taxation of gross interest payable to non-residents is common, it is not usual to tax gross interest payable to domestic lenders. The spread or margin available to domestic lenders in a competitive market may be narrow – often less than one percent and net spreads of 1-2 percent would be considered adequate by many credit institutions. A 15% tax on gross interest of 12% which represents a net interest of 2% would amount to a 90% income tax rate, excessive by any standards.

Recommendations:

1. A consistent tax rate should apply to all interest income.
2. It is suggested net interest, and not gross interest, of all domestic lenders be taxed:
 - a) If gross interest is to be taxed, domestic taxpayers should have the option to file returns and be taxed on net interest with a credit for withholding tax imposed on net interest.
 - b) If gross interest is to be taxed, appropriate measures should be adopted to prevent taxpayers from deducting related expenses from other income.

²⁹ Various GDNT officials differed in their views as to whether the 15% rate or the ordinary corporate rates apply to non-bank credit providers. There appears to be no ruling or official pronouncement used to achieve a consistent policy on this issue.

6. Incorporation

Personal income tax systems often contain special “rollover” provisions to allow sole proprietors to incorporate their businesses and to transfer business assets (inventory, depreciable property, and capital property) to the company without facing tax consequences. The tax character of the transferred property transfers to the company (e.g., cost base of inventory and capital assets and depreciated value of depreciable assets) and the company is treated as if it had always owned the property in question. Thus, if the company were later to sell, say, depreciated property for more than its depreciated book value, there would be a recapture or balancing charge of excess depreciation taken by the original owner that would be treated as income of the company.

Corresponding rules apply to the original owner who incorporates his or her business. The cost base (or depreciated book value of depreciable property) is taken to be his or her cost of shares received in the new company in return for the transfer of the business.

The rationale for the rollover is to allow taxpayers to incorporate their businesses without facing a tax burden. It is assumed that there has been no realization of gain or loss but rather simply a change in the legal form of the business. As a consequence, the rollover rules should preclude the transferor from using the transfer as an opportunity to change the nature of his investment in any fundamental way. Thus, it should be restricted to cases where the transferor only receives shares in the new company in return for the transferred assets and does not also receive debt or other assets.

The rollover rule does not have to be restricted to individuals incorporating their business. It can also apply to partners or members of a cooperative provided each person receives shares in the company equal in value to the property transferred to the company by that person.

Transferred property can be tangible or intangible property such as intellectual property. However, the rollover rule should not apply to goodwill because of the difficulty of valuing goodwill in a non-arm's length transaction. This means that if goodwill is transferred along with the business, the transferor can assign a nil value to the goodwill and the company will acquire any goodwill at a zero cost. If the business is later sold by the company, the entire proceeds for the goodwill component will be taxable. This result is appropriate from a tax policy perspective as it is assumed the original transferor will have already fully recognized the cost of creating the goodwill by deducting the cost of employees' salaries, operating expenses, advertising expenses, and other current expenses that built up the value of goodwill.

Recommendations:

Complementary incorporation rollover provisions should be inserted in the PIT and CIT laws to allow sole proprietors and other unincorporated businesses to incorporate without facing an immediate tax consequence.

7. Corporate reorganizations; rollovers

As noted elsewhere in this report, the Mongolian CIT does not contain comprehensive rules for dealing with relatively common and simply corporate transactions such as distributions other than formal dividends or implicit debt incorporated into sales. Nevertheless, GDNT officials have indicated that reform of the CIT law should not only deal with these fundamental issues, but also address more complex corporate reorganization issues. While these are not prevalent at present in Mongolia, GDNT officials expect transactions of this sort to arise in increasing numbers as the economy develops and rationalization takes place in different sectors of the economy.

While a large number of issues, each of which requires a separate legislative response, fall under the heading “corporate reorganizations”, the same fundamental tax design principles apply to all the issues. The income tax is a “realization” basis tax, meaning accrued gains and losses on assets are recognized for tax purposes only when the taxpayer deals with the assets in a manner that fundamentally changes the nature of the taxpayer’s investment. To take the example of shares, for example, the tax system will recognize gains or losses when a shareholder sells shares, exchanges them for different property (including different shares), makes a gift of the shares, or changes the company articles so value is transferred to the shares from other shares or from the shares to other shares in the company.

Where a transaction takes place entirely within a corporate group, the formal legal transaction may not have any economic effect. For example, as part of a capital reorganization, shares of a particular class may be cancelled and replaced with shares of another class, without the underlying economic rights of the shareholders changed at all. A further example is a disinvestment when a holding company spins off a subsidiary by distributing the shares in its wholly-owned subsidiary so the shareholders own the subsidiary directly rather than through the parent holding company.

Given the pressing need for reform of the fundamental structure of the CIT and the core provisions dealing with basic company tax issues,³⁰ adoption of measures to deal with corporate reorganization would seem to be a second order priority. Nevertheless, consideration could be given to addressing some basic corporate reorganization provisions in the first round of reform amendments.

Corporate reorganizations of non-Mongolian companies will be of interest to Mongolian tax authorities only to the extent Mongolian companies or physical persons own shares in the foreign companies. For the most part, Mongolian tax authorities will be concerned with reorganizations of Mongolian companies owned by other Mongolian companies or domestic or foreign physical persons, and subsidiaries of non-resident company shareholders and “joint venture” companies partially owned by non-resident company shareholders. The tax rules dealing with all types of

³⁰ This point was stressed in the Mann report: "The EIT is in urgent need of an overall framework under which enterprises can enjoy stability and a better sense of security." (Section 1, F).

corporate reorganizations must complement the company law rules and draw upon concepts such as paid up capital, classes of shares, etc. used in company law.

Recommendation:

Consideration be given to the preparation of corporate reorganization provisions dealing with basic corporate reorganizations including share-for-share exchanges, mergers, acquisitions and winding up of subsidiaries, and intra-group asset transfers. Design of specific measures must be based on Mongolian company law concepts.