

Mongolia introduces rules to tax indirect transfer of land rights and exploration and mining licenses

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Executive summary

On 10 November 2017, the Mongolian Parliament approved several amendments to taxation and other relevant laws as part of the 2018 Fiscal Budget. Changes are effective as of 1 January 2018. These include changes to the tax treatment of 'indirect transfer' for the sale of an entity owning land rights or exploration and mining licenses (the Rights) that has been identified as a tax avoidance concern for many years. The amendments are notable in that they mark the first attempt of Mongolia's tax law to embody a rule that seeks to tax beneficial owners rather than immediate holders, thus eliminating an historical narrow view on the sale of rights. These amendments would affect companies operating in all industries in Mongolia that hold land rights and mineral licenses. In short, the following changes are introduced.

- A new tax provision clarifies that the transfer of land rights, including land possession or usage rights and mineral licenses, including exploration or mining rights, are subject to 30% withholding tax on a gross basis.
- Introduction of new tax rules to re-characterize (or deem) all or part of a transaction involving the transfer of the Rights as a direct transfer and tax the beneficial owner, resulting in a 30% tax on the determined taxable base.
- It introduces comprehensive methodologies to determine the taxable base for the Rights transferred, giving the tax authority a right to compare and adjust the transaction value with alternative approaches.
- A new administrative obligation for companies holding the Rights to disclose and register their beneficial owners with the Legal Entity Registration Office (LERO) and tax authority no later than 1 June 2018.
- Taxable legal persons should notify and register the Rights with relevant authorities for any change in beneficial ownership.
- Puts forward sanctions that could terminate the Rights by government agencies for failing to comply with the new rules.

This Alert summarizes the enacted changes. Please refer to following pages for more detailed analysis.

DETAILED DISCUSSIONS

BACKGROUND

Tax treatment of 'indirect transfers' (i.e. the sale of an entity owning land rights and / or mineral licenses by its parent company rather than the rights itself) has emerged as a significant issue for many years. Disposition of company shares is subject to a 10%/25% tax rate depending on the amount of gain only, whereas the tax rate for the sale of rights outright is 30% on gross sales revenue. The tax expense of disposing land and mineral rights would decrease significantly if the transferor and transferee concludes their legal arrangement as a sale of shares, avoiding direct disposal of the rights. It therefore became a commonly observed practice over the years for disposals to be structured as a sale of shares due to the lack of in-depth definition or adequate anti-avoidance rules to counter such approaches. In assessing an appropriate response to this issue, the Mongolian Parliament responded with legal amendments targeted to clarify specifically the indirect transfer of rights involving the disposition of an indirect ownership interest in the rights holder by the beneficial owners. Laws affected by the Budget Bill are the Corporate Income Tax Law (CIT Law), the Personal Income Tax Law (PIT Law), the General Taxation Law (GTL), Law on Land, Law on Legal Registration (LER) and Mineral Law plus two new implementing Guidelines issued by the Ministry of Finance, dated on 25th December 2017. Apart from introduction of new rules, the amendments have significant non-tax implications including various notification and registration requirements for the transfer of the affected rights and basis for terminating such rights by government agencies for failure of administrative transparency obligations.

Please refer to following sections for more details.

WHAT ARE THE TAXABLE OBJECTS?

Direct transfer tax.

A direct transfer involves the disposition of a direct ownership interest in land and mineral rights. Historically there was uncertainty as to whether a sale of land right or a mineral license fell under a category of "sale of rights"

for tax purposes due to the lack of clarity of the definition contained in the CIT Law. With the amendment, the CIT Law now clarifies that the transfer of land rights (i.e., land possession right and land use right) and mineral licenses (mineral exploration rights and mineral mining rights) are treated as a "sale of right" and subject to 30% tax on the gross transfer value. (The tax rate is 10% for individuals on transfer of land rights).

Indirect transfer tax.

The amendment put forward expands the existing direct transfer definition with the introduction of a new indirect tax rule which seeks to tax the transfer of land rights and mining rights at an indirect level. This was prompted by concerns for the possibility of rights being transferred when disposing ownership interest of entity.

HOW TO DETERMINE THE TAXABLE BASE?

Land rights. Under former regime, the tax rate for the sale of land possession rights or land use rights by corporations was at 30% on gross transaction value i.e., the price agreed between the buyer and the seller. However, according to the new rules, the taxable base for the transfer of land rights shall be determined as a value whichever is the higher of the following two values:

- Contract price between the buyer and seller at arm's length basis; or
- Standard value of the initial auction price announced by the respective government agency used for granting land rights to entities or individuals.

Transfer pricing rules apply for land right transfers between related parties, however, the tax authority may refer to the available data for benchmarking purposes if the land rights are transferred free of charge between unrelated parties.

Exploration license. Taxable base for transferring an exploration license shall be by reference to the contract price agreed between buyer and seller on an arm's length basis in the first place. However, the contract price may be disregarded and replaced with certain indirect assessment methods if the contract value is less, by 20% or more, than the lower of the values determined under any of the two indirect methods set out below. If this is the case, the taxable base shall be the lower of the two indirect methods.

Exploration license continued. The indirect assessment methods referred here are:

a) Comparable Benchmark Method. This refers to value from benchmarking data that is available in the database of taxing authorities for similar transactions in same or nearby locations. Under this method, there are certain factors to be considered for comparability purposes which includes location of the site, type of mineral under exploration, quantum of reserve indication, type of geological mineral basin, structure of the mineralization and length of exploration project, size of area, distance from the site to nearest paved roads, railways and distance to accessing basic power facilities. Each of these criteria is rated from 1 to 10 points, being the lowest or highest degree of the comparability. It shall be then deemed to be comparable if the average score of all comparability factors is greater than 7 points. For related party transactions, comparable benchmark method shall be preferred.

b) Cost Based Method. This method should be used where or if the comparable benchmark method is not available. The cost based method refers to the value of all historical costs incurred in relation to the particular exploration license. The total historical costs under this method shall be referred to as the lower of (i) capitalized costs under Exploration and Evaluation Assets account (recognized under IFRS 6) on the balance sheet or (ii) to a sum of exploration costs reported to the Mineral Resources Authority of Mongolia (MRAM) plus historical annual license fees and other related costs.

Mining license. Similar to the treatment of exploration licenses, the taxable base for transferring a mining license shall refer to the contract price agreed between a buyer and seller at arm's length in the first place. However, the contract price may be disregarded and certain indirect assessment methods referred to instead if the contract value is less, by 20% or more, than the lower of values determined under any of the two indirect methods set out below. If this is the case, the taxable base shall be the lower of the two indirect methods. The indirect assessment methods referred here are:

a) Comparable benchmark method. This method refers to the same methodology as those specified for an exploration license valuation. The only difference is that it uses different comparability factors, which are the type of mineral resources to be mined, quality

or grades of the mineral deposits, depth of the mine body, quantity of the mineral reserve, degree of the discovered reserve, type of minerals (placer or prime) and infrastructure indicators such as distance from the mine site to cities, auto road, railway and distance to accessing power facilities. For related party transactions, comparable benchmark method shall be preferred.

b) Net Present Value - based method (NPV based method). This method should be used where or if the comparable benchmark method is not applicable or not available. Under this method taxable base shall be the net present value of the particular mining project. Figure of NPV shall be sourced from the project NPV value to be sourced from the Feasibility Study which has been submitted to MRAM.

Indirect transfer rule

Under the new amendments, the transfer of land rights and mineral rights are not only subject to tax when directly transferred, but they are also subject to tax when they are transferred indirectly, by means of transferring shares in the company. Beneficial owners who meet certain criteria as discussed below shall be subject to the same 30% tax when they transfer their shares in the Mongolian operating entity that holds land rights or mineral licenses (referred hereafter as "Right Holder"), compared to if a direct and outright transfer of rights or licenses is made.

The term "beneficial owner" is broadly defined in the law as a legal person who participates directly or indirectly (through its ownership of shares in one or more legal entities) in control, management or assets of the Right Holder, and who:

- a) Has greatest percentage of voting rights in the Right Holder;
- b) Has greatest percentage of shares or owns the biggest share of the company value in the Right Holder; and/or:
- c) Is in any other similar circumstances in a similar nature to those indicated in (a) and (b) above.

The amount of tax due shall be determined based on pro-rata basis meaning a beneficial owner is taxed from the disposal of its shares for the value which is a proportion of the value of the gross land rights or mineral rights. It should be noted that there shall not be any transfer tax by any other persons who do not meet the criteria of the beneficial owner.

Obligations to report, notify or registrations.

New rules require following key obligations with respect to holding and transferring the land and mineral rights:

- A company holding a mineral exploration license or mining license must register its beneficial owner with the LERO as part of the company records for the current beneficial owner(s). This is also applicable to newly set up companies.
- Any subsequent changes to beneficial owner record of mineral license holders must be notified to LERO each time the beneficial owner is changed based on the proof documents (which should be obtained from the corresponding tax authority) for the payment of tax.
- A company holding a land right or mineral license must register itself and register its beneficial owner(s) with corresponding tax authorities within 10 days of respective change or decision is made.
- In case a beneficial owner(s) indirectly transfers the mineral licenses, the mineral license holders must notify the taxing authority and provide the tax calculation within 10 days.

Failure of such obligations are subject to certain penalties.

Sanction on the failure of tax obligations

In conjunction with the tax treatments outlined in this paper, the other amendments to Land Law and Mineral Law have imposed strict sanctions to ensure greater compliance with respect to transfer of the covered assets. There may be severe consequences for failure to comply with the new tax obligations, including cancellation or revoking the underlying rights. Land rights and mineral licenses will be cancelled by respective authorities if there is a failure to abide by the following obligations:

- The applicable taxes which is due on the transfer of the covered rights are not reported or not paid according to CIT Law or PIT Law (i.e., according to the amendments); or
- The taxpayer intentionally hides information and documents that are necessary for calculating the proper tax base by taxing authorities.
- The taxpayer intentionally provides incorrect information on its beneficial owner details when registering and disclosing them

to LERO and tax authorities (Please note this is applicable to companies holding mineral licenses only)

EY OBSERVATIONS.

With respect to the application of the new rules, we expect some uncertainties and practical difficulties in the area of application of the indirect tax rules, tax assessment methods, withholding obligations and so on. The following are some of the key issues we highlight for considerations:

Beneficial owner definition. The indirect tax rule is likely to create various uncertainties as to how to determine a taxable person under the definition for “beneficial owner”. The law merely provides a general definition for beneficial owner that is read as a person who, directly or indirectly, has the biggest control in the asset holding entity. In addition, the implementing guideline provides some examples of taxable situations where an ultimate shareholder or any other shareholder entity down in the shareholding chain may be taxable in Mongolia from its disposal of shares at any shareholding level. Hence, the term beneficial owner would need more clarity as to who in the entire group structure will be exactly determined as beneficial owner of the mineral license / land holding entities. With this respect, a comprehensive beneficial owner test (e.g., economic / substance activity test or trading test) is further required in order provide more clarity and certainty. At this stage, it is uncertain how the beneficial owner is defined in the group shareholding structure and companies would need to further monitor any developments in this area as precedence may occur.

It also raises an issue of consistency of treatment for shareholdings of different materiality, as the new indirect transfer rule may disproportionately tax the biggest shareholder(s) only whilst other shareholders in the same entity may not be taxed.

For determining the taxable base. In order to test the contract price submitted by tax payers, the tax authority may apply the comparable benchmark methods in determining taxable income for transfer of exploration or mining licenses. This involves referring to databases compiled by the tax authority of similar transactions, where the taxpayers have no knowledge or indication of the comparable data since there is no public access to such benchmarking data.

For determining the taxable base continued.

Therefore, it creates an issue of “secret comparability” by tax authorities. Additionally, it will also create an issue of confidentiality concerns by taxpayers as tax authorities may need to disclose the confidential information of other taxpayers for comparability evidence purposes.

For mining license transfers, the NPV based method may be used in order to test the contract price submitted by taxpayers. This method can be applicable in many instances e.g., to the extent that comparable benchmarking method is not available. If this is the case, using the NPV based method may put at risk the entire NPV value of a mining project at a risk of 30% gross tax which would be an unreasonably high tax cost.

Lack of exemption. Not all transfers of land and mining rights should result in a taxable event. For example mergers or acquisitions may not be taxable events, even if the Rights have appreciated in value, if the transaction satisfies Mongolian tax rules regarding restructuring and reorganization. Lack of reorganization exemption would negatively affect businesses.

Withholding tax obligation. The operating company in Mongolia who is holding the mineral license / land rights are now imposed obligations by law to act as tax agent on behalf of their beneficial owners for the taxes due by the beneficial owners from disposal of their interest at indirect level. Hence, the beneficial owners would need to inform or notify the operating company for any transfer of the shares at an indirect level.

ACTIONS REQUIRED

The amendments to GTL and the LER Law provides a window period of 5 months starting from the effective enforcement date to get companies registered with government authorities. In this respect the following actions are required by affected companies:

- The holding a mineral exploration license or mining license must register its beneficial ownership with LERO by 1 June of 2018.
- The companies holding land use rights, land possession rights, mineral exploration licenses or mining licenses must register their beneficial ownership with tax authority by 1 June of 2018.

EY ASSISTANCE

EY’s experienced tax and transfer pricing team will be able to assist clients in addressing these new requirements. Our services can include the following:

- Provide assistance in identifying the beneficial owners of land rights or mineral license holders.
- Provide assistance in registering beneficial owner(s) of the affected holder with LERO or tax authorities which is due before 1 June 2018.
- Provide assistance in transferring the land rights and mineral licenses either at a direct or indirect level. This includes assistance in estimation of tax obligations, filing required documents, and in getting tax clearance letters and notifying for the change of the beneficial owner.
- Assist in identifying the transfer pricing and arm length analysis for the transfer of covered rights amongst related parties including comparability and benchmarking analysis.
- Planning services for holding the land rights or mineral licenses to mitigate the indirect tax exposures at exit.

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