

Tackling multinational tax avoidance in **Mongolia**

From building modern legal frameworks and mining industry expertise to a major audit outcome





Context

Mongolia is the second largest land-locked country in the world and is endowed with significant natural resources. With a long and proud history spanning back to the Middle Ages, Mongolia's modern era is marked by its entry into the market-based economy in the early 1990s following the collapse of the Soviet Union.

Today, Mongolia's two main economic sectors are agriculture and mining. It is these two sectors that have served as the catalyst for a substantial increase in foreign trade and investment for Mongolia. While foreign investment fuelled economic growth, it has also brought about challenges requiring Mongolia to develop a legal framework to regulate the activities and operations of multinational enterprises. Notably, the mining sector in Mongolia is dominated by multinational companies and in 2019 accounted for 19% of Mongolia's Gross Domestic Product as well as 94% of export value.¹ Despite this, it has not provided a commensurate contribution in government revenues. The reasons for this are complex, however, two significant underlying factors have been the aggressive base erosion and profit shifting (BEPS)² strategies employed by some multinational mining companies and the limited human resources and experience within the Mongolian General Department of Taxation to tackle the BEPS issue. To address this, Mongolia sought assistance from international partners.

In 2015, Mongolia became a member of the Intergovernmental Forum on Mining, Minerals, Metals, and Sustainable Development (IGF)³, with whom it carried out a detailed assessment of its Mineral Policy Framework⁴. In 2017, Mongolia joined the OECD/G20 Inclusive Framework on BEPS and, in 2018, the Global Forum on Transparency and Exchange of Information for Tax Purposes⁵ (Global Forum) to modernise its legal framework, build capacity to tackle complex tax schemes and to implement the international

standards on transparency and exchange of information (EOI) for tax purposes (Box 2). Furthermore, in early 2019, Mongolia requested a mining taxation technical assistance programme from the OECD and IGF (Box 1). Later that year, the OECD and IGF launched their flagship 'BEPS in Mining Deep Dive' programme in Mongolia, alongside a Tax Inspectors Without Borders (TIWB)⁶ programme.

“ *The year 2019 was very eventful for Mongolia in terms of taxation. It is characterised by a policy change, an enactment of tax laws, an administrative upgrade of the tax information system, and an enhancement of co-operation between the tax administration and international organisations. On top of joining the OECD/G20 Inclusive Framework on BEPS, the Global Forum in the previous years, and benefiting from the IGF-OECD BEPS in Mining Deep Dive programme, the tax administration has put a special emphasis on tackling tax avoidance, fostering domestic revenue mobilisation and promoting its international co-operation.* **”**

Mr Zayabal Batjargal,
Commissioner, General Department of Taxation Mongolia



Mongolia closes the tax gap in the mining sector by issuing a tax assessment of USD 228 million and denying USD 1.5 billion in carried forward losses.

Mongolia reduces the tax gap in the mining sector

Fourteen months after the launch of the BEPS in Mining Deep Dive and TIWB programmes, the Mongolian General Department of Taxation issued its first transfer pricing^{7,8} assessment as part of a comprehensive audit of a large multinational mining company, resulting in **USD 228 million and a denial of USD 1.5 billion in carried forward losses**. The bulk of this assessment came from the work of a small transfer pricing team that was formed in October of 2019 and although the matter has not been fully resolved, it is notable that the taxpayer has paid the USD 228 million tax assessment in full. These significant results were achieved through a combination of effective partnership between Mongolia and the OECD, IGF and TIWB, a willingness from the General Department of Taxation to effect institutional change, and the tenacity of talented auditors.

“ *The transfer pricing audit conducted with the essential technical assistance provided by the TIWB, IGF and OECD experts, is a major step forward for the Mongolian Tax Administration. The resulting tax assessment is a testament to the capabilities of the Mongolian tax officials as well as the combined international effort to tackle global tax avoidance. The tax administration has accomplished bridging the years of gap. The audit case is an important milestone for the development of the tax system in Mongolia and addressing the BEPS issues.* ”

Mr Zayabal Batjargal,
Commissioner, General Department of Taxation Mongolia

Box 1: Improving technical assistance through partnerships in the mining sector

For many developing countries, revenues from the mining sector present a significant opportunity to grow the economy and fund vital public services. Ensuring governments have the knowledge, skills and tools to build and administer mining tax systems is, therefore, critically important.

The OECD and IGF have been working together since 2017 to help developing countries address BEPS issues in the mining sector. It is a unique partnership that combines IGF's mining expertise with the OECD's knowledge of international taxation as it relates to the extractive sector. The joint programme focuses on helping countries to effectively administer their mining and international tax laws to ensure they capture a fair share of the fiscal benefits from their resources. It also provides advice on designing robust laws and policies to safeguard mining revenues.

The OECD/IGF BEPS in Mining Deep Dive programme is a long-term technical assistance programme that spans 2-3 years and provides sector-specific guidance on BEPS challenges and capacity building support, including training, legal and policy advisory services, as well as hands-on tax audit assistance. Beneficiaries of the programme are selected countries in Africa (delivered together with the African Tax Administration Forum), Asia and the Pacific, and Latin America.



Practical hands-on assistance from mining and tax audit experts



TIWB is a well-known joint initiative of the OECD and the United Nations Development Programme (UNDP) that aims to increase auditing capacity for tax administrations in developing countries through its 'learn by doing' approach. Since its creation in 2015⁹, TIWB has primarily focused on building international tax audit capacity. Audits in complex industries such as mining, however, have been a challenge due to the specialised knowledge that is required to separate industry practice from tax-driven schemes. The partnership with the OECD/IGF's BEPS in Mining programme was a unique opportunity for TIWB to combine transfer pricing and audit expertise offered by TIWB Experts, with mining specialists from the OECD and IGF. This innovative approach has enabled the respective OECD, IGF and TIWB programmes to effectively meet the demand from resource rich developing countries for a holistic solution to combat tax avoidance in the notoriously complex extractive sector.

In a short space of time, the partnership between TIWB, the OECD/IGF's BEPS in Mining programme, and the General Department of Taxation, has delivered important results for Mongolia.

- **Creation of inaugural Transfer Pricing Division within the General Department of Taxation:** In October 2019, the General Department of Taxation established the Transfer Pricing Division which focuses on tax compliance concerns originating from related party arrangements of multinational companies. The transfer pricing focus was also intended to complement compliance initiatives that would arise from Mongolia's new transfer pricing laws as part of the BEPS project. The prompt execution of the recommendation to establish a Transfer Pricing Division would prove

to be pivotal in Mongolia's ability to tackle egregious transfer pricing abuses and issue one of the largest tax assessments on record in the extractive sector.

- **Procuring world-leading databases and acquiring hands-on practical experience on transfer pricing benchmarking:** In late 2019, the OECD provided advice to the Mongolian General Department of Taxation on the database options that are available to undertake transfer pricing benchmarking studies. The advice included co-ordinating the trial of these databases as part of the appraisal process. The written advice and practical trials provided a thorough process for the General Department of Taxation to evaluate its options, eventually leading it to conclude in favour of investing some of its limited financial resources on subscriptions on the most appropriate database. This investment was critical, allowing the General Department of Taxation to perform reliable transfer pricing benchmarking which formed the basis of its transfer pricing assessments.
- **Acquiring knowledge and capacity to analyse the interaction between the domestic tax law, mining contracts, and international law:** In 2020, IGF provided capacity building to the General Department of Taxation to analyse and interpret mining contracts. A mining contract is a legal agreement between a host government and a mining investor. They often contain a stabilisation provision that purports to limit the ability of the host government to change the fiscal law applicable to an investor. The capacity building helped the General Department of Taxation understand the complex interaction between investment contracts with domestic and international law; and will inform future mining contract negotiations and renegotiations in Mongolia.

Building on successes and modernising the tax legal framework



Tax audits are only as effective as the tax laws that underpin them. It is critical that developing countries have strong domestic and international tax law frameworks in place, including in relation to important economic sectors such as mining.

Implementation of international standards on transparency and EOI

Tax transparency and EOI is one of the fundamental pillars in the fight against tax evasion and avoidance

allowing tax administrations access to key data for audits and risk assessments.

As a Global Forum member, Mongolia is committed to implementing the tax transparency standards. Through the Global Forum's intensive capacity-building programme (Induction Programme) jointly delivered with the Asian Development Bank (ADB), Mongolia is receiving high-quality assistance to put in place the legal and practical framework to implement EOI and enhance domestic resource mobilisation.



Launch event of the OECD and IGF's BEPS in Mining Deep Dive programme in Ulaanbaatar, Mongolia (August 2019).

Modern transfer pricing rules

In 2018-19, in parallel with the BEPS in Mining and TIWB initiatives, the OECD worked with the Mongolian Ministry of Finance to modernise its international tax law framework and provided support to implement some of the key recommendations of the OECD/G20 BEPS Project.

Prior to 2020, Mongolian laws governing related party transactions were contained in three different laws – the Personal Income Tax Law, Corporate Income Tax Law and the General Taxation Law. Due to the varying language in the respective laws, it was often difficult for both taxpayers and tax officials to understand and apply them.

The new legislative framework, which entered into force in 2020, consolidates the key transfer pricing provisions into the General Taxation Law, and secondary laws further regulate how taxpayers should comply with the arm's length principle, and how they should document and report on these transactions.

These significant legislative changes were supported by effective capacity building initiatives delivered by the OECD to the General Department of Taxation focussing on the practical aspects of administering the modern tax framework.

Valuing mining licenses to prevent capital gains tax losses

Having received technical advice and capacity building from the OECD and IGF, Mongolia was able to introduce new regulations on how mining and exploration licenses should be valued for capital gains tax purposes. Prior to this, mining and exploration companies had been able to choose the method that required them to pay the least amount of tax in Mongolia. The new regulations outline commonly accepted valuation techniques, thereby limiting opportunities for tax avoidance and protecting Mongolia's tax base. They also provide certainty for investors on the appropriate valuation methodologies to use when calculating capital gains tax.

Ring-fencing mining income to avoid delaying government revenues

Mongolia recently introduced "ring-fencing" rules, which prevent mining companies with multiple projects in Mongolia from offsetting losses from exploration or early-stage projects against taxable profits from mature, income generating extractive assets. This practice has often meant that these companies can delay paying corporate income tax, sometimes for years. The OECD and IGF provided technical input into the drafting of the new ring-fencing rules, as well as ongoing capacity building on implementation. By preventing the artificial delay in corporate tax payments, the ring-fencing rules will bring forward tax collection, providing a vital injection of funds for Mongolia, while also making the timing and amount of tax due easier to predict.

Box 2: Improved access to information and a strengthened EOI network to tackle tax evasion and avoidance

Mongolia carried out significant structural reforms to implement the EOI standards, including:

- elimination of bank secrecy for EOI for tax purposes;
- provision of the necessary access power to the General Department of Taxation to carry out EOI requests;
- updating of the anti-money laundering legislation, with all legal entities now obliged to report their beneficial owners to the Registration Office.

Further, on November 2019 Mongolia signed the Convention on Mutual Administrative Assistance in Tax Matters (the MAAC)¹⁰ and its ratification followed in June 2020. The MAAC is a multilateral treaty that provides countries an international legal framework for exchanging information and co-operating in tax matters with the goal of countering international tax evasion and avoidance. By joining the MAAC, Mongolia significantly expanded its administrative cooperation framework. Over 140 countries and jurisdictions participate in the MAAC.



Lessons learned

The extractive sector has the potential to drive significant economic growth and contribute to domestic resource mobilisation for developing countries. Despite the significance of the sector, Mongolia's experience demonstrates the immense challenge of collecting taxes and the egregious level of tax avoidance that is occurring in the extractive sector within some developing countries. The OECD, IGF and TIWB's ongoing work in the extractive sector recognises that there is still much more work to be done beyond Mongolia in other resource-rich developing countries. Since 2015, the OECD and IGF have been assisting more than 37 resource-rich developing countries and launched five active Deep-Dive programmes.

The experience in Mongolia has also provided insights into a more effective capacity-building model – one which is outcomes and results focused. In particular, the model centres on and favours:

- 1. Long-term investment in capacity building** – it takes time for tax officials to develop the necessary technical and industry knowledge to effectively implement compliance initiatives. The OECD, IGF, TIWB, Global Forum and ADB committed long-term resources to building the capabilities of Mongolian tax officials. Correspondingly, senior government officials in Mongolia facilitated this approach by making available staff with the appropriate background and skillsets for the development programme. The International Monetary Fund, the World Bank Group, Japanese International Cooperation Agency and other development partners were also instrumental in assisting the General Department of Taxation to create the institutional and legal foundations needed to build a sustainable tax system.
- 2. Multi-faceted and mutually reinforcing technical assistance** – the OECD, IGF, TIWB, the Global Forum and ADB coordinated their collective resources and expertise to help Mongolia address the most pressing tax gaps through a combination of legal and policy reforms, as well as improving tax administration. The OECD, IGF, Global Forum and ADB worked with the Ministry of Finance and the General Department of Taxation to modernise the legal framework, whilst TIWB provided the capacity building that was needed for tax officials to effectively administer the law. This development model was also instrumental in facilitating more regular communication between the various government agencies, such as the Ministry of Finance, General Department of Taxation and Ministry of Justice, which is critical to combat tax evasion and avoidance.
- 3. Mining focus and expertise** – mining has the potential to transfer real economic wealth to local communities. The magnitude of the sector cannot be understated, accounting for more than 20% of Gross Domestic Product (GDP) for 41 developing countries, and more than 10% of GDP for a further 13 developing countries in 2019¹¹. Undertaking tax compliance initiatives and setting appropriate tax policies in the extractives resources sector requires a combination of industry, tax policy and tax compliance knowledge. Very rarely will a single organisation have all the necessary expertise that is needed to deliver such a wide-ranging scope of technical assistance. The successful collaboration between the OECD, IGF and TIWB showcases how powerful partnerships can be in order to enhance the quality of technical assistance and remove the potential for duplication.
- 4. Strong ownership by government institutions** – senior government officials were highly motivated to build the General Department of Taxation's capacity to carry out successful transfer pricing audits in the mining sector. They were flexible and agile in their response to expert advice, and prompt in assembling a strong team of auditors to form Mongolia's first transfer pricing unit. They provided dynamic leadership throughout the programme, spearheading the tax audit, and ensuring decisive policy and organisational reform.

Outlook



The success of Mongolia's first transfer pricing audit has encouraged the General Department of Taxation's Commissioner to make transfer pricing compliance a priority for the coming years, particularly in the mining sector. To this end, TIWB doubled its efforts to support Mongolia with the launch of two new programmes in 2021. Similarly, the OECD and IGF are supporting an expansion in transfer pricing capacity building initiatives to the General Department of Taxation's Large Taxpayer Office and District Offices. This includes training auditors on the application of Mongolia's new transfer pricing laws, risk detection and data analytic techniques to identify high-risk international related party transactions, including financing, intra-group services, asset transfers and under-pricing of Mongolia's primary mineral exports – all of which have proven to be key profit shifting risks in the mining sector.

The OECD and IGF continue to work with the General Department of Taxation to strengthen its implementation of legal reforms. This includes capacity building workshops on topics such as ring-fencing, as well as other demand-driven technical advice. In 2021, Mongolia received its first lodgements of Country-by-Country reports, Master Files and Local Files. Using this information effectively for risk detection and assessment purposes has also become a high priority for the General Department of Taxation. The OECD has therefore been working with the General Department of

Taxation's risk assessment team to provide an effective framework to incorporate this new data set into existing risk detection algorithms.

Finally, the OECD is providing ongoing assistance to Mongolia's Ministry of Finance as part of its efforts to improve the Mongolian legislative framework to tackle BEPS related challenges. Addressing the abuse of bilateral tax treaties is a priority for the country as they work through the signing and ratification of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting¹² (known as Multilateral Instrument or MLI) and completing the steps necessary for enabling the automatic exchange of information.

“ The Mongolian Tax Administration, standing firm on its previous successes, will uphold its international commitments against global tax avoidance, foster domestic revenue mobilisation, and will continue to enhance co-operation with international partners.

Mr Zayabal Batjargal, Commissioner, General Department of Taxation Mongolia



The OECD is providing ongoing assistance to Mongolia's Ministry of Finance as part of its efforts to improve the Mongolian legislative framework to tackle BEPS related challenges.



Notes

1. Gross Domestic Product (2021) report, National Statistics Office of Mongolia, https://www.1212.mn/BookLibraryDownload.aspx?url=GDP_2020Q4_en.pdf&ln=En.
https://www.1212.mn//stat.aspx?LIST_ID=976_L14&type=tables, retrieved July 2021.
2. <https://www.oecd.org/tax/beps/>.
3. <https://www.igfmining.org/>.
4. https://www.iisd.org/system/files/publications/mongolia-mining-policy-framework-assessment-en.pdf?utm_campaign=mongolia-mpf&utm_medium=post&utm_source=website-IGF.
5. <https://www.oecd.org/tax/transparency/>.
6. <http://www.tiwb.org/>.
7. Transfer pricing refers to the process to which Multinational Enterprises (MNE) set the price of intragroup transactions. The arm's length principle is the international transfer pricing standard that OECD member countries have agreed should be used for tax purposes to govern intragroup transactions by MNE groups and tax administrations. For more details see the OECD (2017), OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017, OECD Publishing, Paris, <https://www.oecd.org/tax/transfer-pricing/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm>.
8. <https://www.oecd.org/tax/tax-global/work-on-extractive-industries.htm>.
9. OECD/UNDP (2020), "Tax Inspectors Without Borders Annual Report 2020", <http://www.tiwb.org/resources/reports-case-studies/tax-inspectors-without-borders-annual-report-2020.htm>.
10. <https://www.oecd.org/ctp/exchange-of-tax-information/convention-on-mutual-administrative-assistance-in-tax-matters.htm>.
11. World Bank Group and World Mining Data
12. <https://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm>.



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