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# SOME TAXING QUESTIONS



*A series of important changes to Mongolia's tax legislation, implemented as an adjunct to the approval of the State Budget in November 2017, are currently having a significant impact on FDI flows into the country.*

## Background

Effective from 1 January 2018, Mongolia introduced changes to its Minerals Law, Land Law, Law on Registration of Legal Entities and various tax specific laws, with the aim of increasing tax revenues by way of a 30% tax on the direct or indirect transfer of rights in land and minerals licences.

It was already the case that a direct transfer of a license or right itself would be subject to 30% tax, which led to the common practice of transferring shares in the Mongolian company holding such right in order to seek to reduce the tax burden to 10%, the standard basic Corporate Income Tax rate. In practice, the General Tax Authority had been treating any share transfers in Mongolian companies holding such rights as a deemed transfer of the right or licence and looking to levy tax at 30%.

While this addressed onshore transactions to an extent, the changes to the laws are significantly more far-reaching, and seek to capture the transfer of a controlling interest in land or mineral rights offshore, regardless of jurisdiction.

## What is being taxed?

The main objective of the changes is to impose tax on persons obtaining income from the indirect sale of Mongolian rights to a third

party. If this takes place offshore, for example by way of the sale and purchase of shares in a BVI company ultimately holding Mongolian mining licences, there would be no tax benefit to Mongolia arising out of the transaction.

## Implementation and Government leverage

The changes introduced a novel concept in Mongolian law of "beneficial ownership", a well-known feature of common law jurisdictions, but less so for civil law systems like Mongolia. The concept was first introduced in the Securities Market Law of 2012, in connection with the holding of shares by custodians or nominees on behalf of investors, but it is still relatively new to the Mongolian market.

In a development reminiscent of the SEFIL law of 2012, which sought to control foreign investment into strategic sectors of the Mongolian economy such as Mining and Banking, companies holding land or mineral rights were obliged to disclose their beneficial holders to the Mongolian authorities by a specific date, in this case, 1 June 2018. Failure to do so could constitute grounds for revocation of the licence.

The disclosure of "beneficial holders" to the State Registration body is designed to provide the underlying information on which the Mongolian authorities may act in the event of an indirect transfer of rights.

*“ Importantly, payment of the tax itself is the legal responsibility of the Mongolian company actually holding the land or mineral rights, enabling the Mongolian authorities to take direct action without having to take enforcement action offshore. In addition, the tax is to be paid within 7 days of the completion of the transaction resulting in a change of beneficial owner. ”*

## What are the concerns?

Both international and domestic trade organizations have expressed a number of valid concerns with the implementation and effect of these amendments. Some observations on the revised legislation include the following:

- The definition of “beneficial holder” is unclear and is based on the common law contractual concept of control, which includes the idea of directing control through management or assets. This leaves a significant amount of discretion.
- The current position is that in the case of a sale resulting in a change of control of shares, the tax will be assessed on the basis of the higher of the sale price and the valuation of the right itself. When acquiring a business, for example including land rights, these may only constitute a small part of the valuation of the business as a whole.
- The basis of valuation of the land right or mineral licence itself is unclear and open to varying interpretations.
- Offshore listed companies do not have control over trades in their shares. In certain cases, this legislation effectively acts as a “poison pill” in respect of M&A transactions for Mongolian assets, preventing the operation of a free market for offshore investors, and potentially limiting the development of the underlying assets themselves.
- A rate of tax of 30% is significant in any transaction involving Mongolian land and mineral assets, and operates as a disincentive to investment transactions.

- If the licence holder is made responsible for payment of the tax, it complicates group-wide accounting when the real benefit is offshore, and the time period for payment of tax does not allow for intra-group solutions to be put in place in a timely way.

## Conclusions

While well intentioned, these changes have been implemented with inadequate public and advisory consultation. It seems that the lessons of the 2009 Windfall Tax and the 2012 Strategic Investment Law have not been taken on board.

*“ Based on the general market reaction, instead of the desired effect of increasing Mongolia’s tax revenues, the principal outcome has been to disincentivize foreign and domestic investment, which overall will reduce the attraction of Mongolia as an investment destination and limit the vitality of the private sector, which should be the main engine for overall economic growth. ”*

Anecdotally, transactions relating to land rights and mineral licenses are now being put on hold, delayed, restructured or entirely reconsidered as a result.

A quick fix approach without proper stakeholder consultation has not stood the test of time, and this is the key takeaway from the tax law amendments. While speculative investment is always undesirable, it is hoped that these amendments will be removed or amended in a way that will facilitate the growth of the private sector, and not put the brakes on growth at a time when commodity prices are in an upward cycle and positive for the Mongolian economy.

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