



# Mongolia Transfer Pricing Alert

7 June 2019

## Mongolia upgrades its transfer pricing regulations

### Executive summary

Mongolia has just revised its key tax laws including the General Law on Taxation, Corporate Income Tax Law and Personal Income Tax Law. The new laws were adopted by the Mongolian Parliament (the legislative body) on 22 March 2019, under the Government's tax reform packages.

A number of important changes that may have a material impact on taxpayers, requires taking appropriate actions to comply with the new requirements. Amongst others, the transfer pricing laws and associated rules have been upgraded to catch recent international developments and standards.

We have highlighted key changes in this alert regarding the transfer pricing developments.

The Ministry of Finance is to release a number of implementing guidelines on the new rules.

The new tax rules shall take effect on 1 January 2020.

## Technical details

### Overview of Transfer Pricing developments

Various sections in the current tax laws refer to the need for transactions between related parties to be conducted on an arm's length basis. Failing this, the tax authorities may seek to adjust the transaction to a fair market value (so-called "Transfer Pricing rules").

The transfer pricing rules are currently spread over various individual tax laws including General Taxation Law (GTL), Corporate Income Tax Law (CIT), VAT Law, Personal Income Tax Law (PIT), etc. Historically, there have been certain issues, uncertainties or conflicts with regards to interpretation of various rules in the separate laws. For instance, the definition for related party is defined differently in the GTL and CIT Law and it raises a practical issue on which definition is overridden.

With new transfer pricing laws, there will be a single, all-encompassing transfer pricing legislation that will be governed mainly by the General Taxation Laws and its associated guidelines. This will replace separate rules found in different tax laws, such as the Corporate Income Tax and Personal Income Tax Law.

### Re-defines definition for 'related parties'

Both transfer pricing provisions in the CIT Law and GTL have clauses which define related parties to include entities which are connected in terms of management of control and/or ownership. In particular:

- Article 48.4 of the GTL- related party shall mean 'bodies who are authorized to participate directly or indirectly in the management, control or ownership' of other entities.
- Article 6.1 of the CIT- if the following relation is present with a taxpayer, it shall be a related party: 1) owns 20% or more of the common stock of the other entity; or 2) has the right to receive 20% or more of the dividends or distributions from the other entity; 3) has the right to appoint 20% or more of the management of the other entity or is otherwise able to determine its policies).

There has been a need to redefine above definitions as there were some concerns that it may have some weaknesses and it is quite narrowly defined which causes a risk of not capturing certain related party transactions. It is sometimes interpreted that it only applies to entities with direct ownership and it may not be able to cover two entities under common control.

Under the new transfer pricing rules the legislators have re-defined and expanded the definitions for related parties as outlined below. The manner in which related party relationship are defined is now more broadly aligned with international practices. However, the threshold of 20% for triggering a related party relationship is relatively low.

#### *Article 27 of New GTL - Related parties:*

*The entities listed below shall be considered to be related parties who are possible to influence each other on the conditions or economic outcome of a transaction by a way of direct or indirect participation, by a person in the other, or the same person in two or more persons, of the assets, control or managerial activities, including:*

- 1. Taxpayer's parents, blood sisters and brothers, grandparents, children and grandchildren; or taxpayer's spouse or partner (cohabitant), or their parents, or their blood sisters and brothers;*
- 2. Members of the same group. A group is further defined in the law as the related persons those which are related in their ownership or management and consolidated for financial reporting purposes.*
- 3. If one person directly or indirectly holds 20% or more of the share, participation or voting rights in other entity;*

4. *If one person has a right to directly or indirectly participate 20% or more of the profits or liquidation proceeds in other entity;*
5. *Entities who are controlled by third same person who directly or indirectly holds 20% or more of the share, participation or voting rights in such entities;*
6. *Entities who are controlled by third same person who has a right to directly or indirectly participate 20% or more of the profits or liquidation proceeds in such entities;*
7. *Entities stipulated in items #3 -6 above if controlled by individuals specified in item #1 i.e., entities in separate groups which are under common control by same individuals.*
8. *Representatives, nominees or assignees of the parties stipulated in this section.*
9. *Branch office or other forms of permanent establishments of related parties*
10. *A unrelated person with a main purpose of reducing taxable income or increase tax losses of Mongolian tax residents*
11. *Other persons similar to preceding nature.*

In addition, there may be circumstances for unrelated parties to be treated as related parties in case they have entered into an arrangement on which parties have agreed a common position or common interest with their decision for a particular transaction.

### **Transfer pricing documentation requirements**

According to transfer pricing regulations, taxpayers are required to maintain contemporaneous documentation in order to comply with the arm's length standard. The transfer pricing documentation should substantiate a taxpayer's assertion that, given the available data and the applicable pricing methods, the chosen method (and its application) provided the most reliable measure of an arm's length result under the arm's length standard.

As per recommendations made in Action 13 of the BEPS (Base Erosion and Profit Shifting) project of the OECD (Organisation for Economic Co-operation and Development), and revised texts of chapter V of the OECD Transfer Pricing Guidelines, Mongolia now will require taxpayers with related party transactions to adopt the internationally-standardized three-tiered approach to transfer pricing documentations which are:

- a) **Master File** - containing standardized information relevant for all MNE group members;
- b) **Local File** - referring specifically to the activities and material related party transactions of the local (Mongolian) taxpayer; and
- c) **Country-by-Country Report (CbCR)** - containing certain information relating to the global allocation of the MNE's income and taxes paid together with certain indicators of the location of economic activity within the MNE group.

The main objectives of updated transfer pricing documentation requirements are to ensure that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices between related parties; to provide tax administrations with the information necessary to conduct an informed transfer pricing risk assessment; and to provide tax administrations with useful information to employ in conducting an appropriately thorough audit of the transfer pricing practices of entities subject to tax in their jurisdiction.

**Master File.** The master file should provide an overview of the MNE group business, including the nature of its global business operations, its overall transfer pricing policies, and its global allocation of income and economic activity in order to assist Mongolian tax administrators in evaluating the presence of significant transfer pricing risk. In general, the master file is intended to provide a high-level overview in order to place the MNE group's transfer pricing practices in their global economic, legal, financial and tax context.

Under the new laws, the information required in the master file provides a "blueprint" of the MNE group and contains relevant information that can be grouped in the following categories:

- a) the MNE group's organizational structure;
- b) a description of the MNE's business or businesses;
- c) the MNE's intangibles;
- d) the MNE's intercompany financial activities; and
- e) the MNE's financial and tax positions.

**Local File.** In contrast to the master file, which provides a high-level overview as described above, the local file provides more detailed information relating to specific activities and intercompany transactions relevant to Mongolia. The information required in the local file supplements the master file and helps to meet the objective of assuring that the taxpayer has complied with the arm's length principle in its material transfer pricing positions affecting Mongolia. The local file focuses on information relevant to the transfer pricing analysis related to transactions taking place between a local country affiliate and associated enterprises in different countries and which are material in the context of the local country's tax system. Such information include relevant financial information regarding those specific transactions, a comparability analysis, and the selection and application of the most appropriate transfer pricing method.

**Country-by-Country Report.** The CbCR requires aggregate financial information per jurisdiction an MNE group operates relating to the global allocation of the MNE group's income, the taxes paid, and certain indicators of the location of economic activity among tax jurisdictions in which the MNE group operates. The report also requires a listing of all the Constituent Entities for which financial information is reported, including the tax jurisdiction of incorporation, where different from the tax jurisdiction of residence, as well as the nature of the main business activities carried out by that Constituent Entity.

The CbCR will be helpful to tax authorities for high-level transfer pricing risk assessment purposes. It may also be used by tax administrations in evaluating other BEPS related risks and also for economic and statistical analysis. The new laws made it clear the information in the CbCR shall not be used as a substitute for a detailed transfer pricing analysis of individual transactions and CbCR on its own does not constitute conclusive evidence that transfer prices are or are not appropriate. It shall not be used by Mongolian tax administrations to propose transfer pricing adjustments based on a global formulary apportionment of income.

MTA will be further introducing detailed tax and transfer pricing reporting forms on the above transfer pricing reports.

## Timing of filing transfer pricing documentations

Type of documents	Deadline	Who shall file?
Transfer Pricing Transactional Report (an annual report) (New GTL doesn't provide a description on the content of this report and it is expected to be further clarified with upcoming implementing guidelines)	10 <sup>th</sup> of Feb following the year end	All taxpayers with related party transactions
Master File	10 <sup>th</sup> of Feb following the year end	Companies or group with annual turnover of more than MNT 6 billion for preceding tax year; or foreign invested companies irrespective of size.
Local File	10 <sup>th</sup> of Feb following the year end	Companies or group with annual turnover of more than MNT 6 billion for preceding tax year; or foreign invested companies irrespective of size.
CbCR	Within the 12 period after the last day of group financial year	A group parent entity which resides in Mongolia; or other assigned entities

Taxpayers shall be required to provide additional information related to transfer pricing documentations pre or during the tax audits.

## Threshold and exemption from transfer pricing documentation obligations

While most countries typically require taxpayers to prepare transfer pricing documentations if the amount of transaction exceeds certain threshold at transactional level in order to prevent disproportionate high costs and administrative burdens, Mongolia has not set any threshold to exempt smaller transactions from transfer pricing documentation obligations. Instead, SME group companies under MNT6 billion annual turnover is exempt from certain transfer pricing documentations that of local file and master file. CbCR threshold is set at MNT1.7 trillion or approx. EUR 630 million (while OECD's recommendation was EUR 750 million).

## Administrative penalties for failure of transfer pricing documentation obligations

As outlined in the table above, all transfer pricing documentations are required to be submitted by taxpayers to Mongolian tax authorities within the specified timeframe by law.

The new rules have imposed severe administrative penalties for failure to comply with transfer pricing documentation requirements i.e., if transfer pricing documentations are not filed to tax authorities within the specified deadline, there will be automatic penalties. These automatic administrative penalties are equal to 2% - 4% of transaction value (as set out in the table below), apart from penalties and fines resulting from transfer pricing adjustments (if any).

Type of documents	Automatic administrative penalty	Frequency
Transfer Pricing Transactional Report (an annual report)	2% of respective related party transaction value	Per non-compliance
Master File	3% of respective related party transaction value	Per non-compliance
Local File	3% of respective related party transaction value	Per non-compliance
CbCR	4% of respective related party transaction value	Per non-compliance

## **OECD Transfer Pricing Guideline treatment / reference**

Despite the fact that Mongolia is not a member of the OECD, Mongolia has endorsed the OECD Transfer Pricing Guidelines in the General Taxation Law. With this, OECD Transfer Pricing Guidelines may be applied by Mongolian tax authorities for assessing pricing arrangements of the related parties provided that OECD Transfer Pricing Guidelines doesn't conflict with arm's length principles set out in the domestic tax laws and relevant implementing guidelines.

## **Actions Required**

The above new requirements will have wide-ranging impact on taxpayers with respect to information collection and processing, group transfer pricing policy setting, and preparing various transfer pricing reports and filing them to taxing authorities within the specified deadlines.

It is strongly recommended that the local group companies or MNEs proactively address the new requirements as soon as possible in order to avoid unnecessary administrative penalties or other transfer pricing audit risks. Focus would be on evaluating aspects such as the global tax framework, the value chain related to the Mongolian business, and whether related party pricing arrangements are reasonable. These initiatives will require extensive assistance and cooperation from the ultimate parent company of the MNE and its affiliates (including Mongolian companies).

Practically, these new transfer pricing documentation requirements will create additional compliance and due diligence work for taxpayers. It is expected that it will be time consuming to arrange the internal department structure and business processes to perform the work required, and to collect overseas related party information.

Based on the new transfer pricing risk assessment tools, MTA would likely select the target companies for special transfer pricing audits. Therefore, it is important that taxpayers pay special attention to the information provided in the new forms submitted. Incomplete or inconsistent filings or documentation could attract the attention of the MTA and lead to transfer pricing audits.

## **EY assistance**

EY seasoned transfer pricing teams will be able to assist clients in addressing these new requirements. EY services/the services can include the following:

- Providing guidance on the input required and assisting with the preparation of the new TP report and associated disclosures.
- Review and health check of existing group transfer pricing policies to identify tax and transfer pricing risks associated with intercompany pricing arrangements.
- Preparing transfer pricing documentation required by local regulations including Master File, Local File and CbCR as well as comparability/benchmarking studies.
- Planning services for establishing new transfer pricing policies and operating models.

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