EUROCHAMBER MONGOLIA
ЕВРОП МОНГОЛЫН ХАМТАРСАН ХУДАЛДАА АЖ ҮЙЛДВЭРИЙН ТАНХИМ

POSITION PAPER
INDIRECT TRANSFER TAX RULE

regarding transfer of mineral licenses

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Relevant Industries
The indirect transfer tax rule ("**ITTR**") applies to transfer of exploration and mining licenses in the discoveryand production of minerals, radioactive minerals and oil and gas in Mongolia.

Recommended Changes to the Current Law
1. **Change the methods for valuation of mineral license transfers for tax purposes**
2. **Change the level of deductibles on the ITTR to include normal business expenses**

1. Valuation of Mineral License Transfers for Tax Purposes

A summary of the methods used to value mineral licenses
The value of a license will be computed based on the following methods:
- Cost-based method
- Income-based method (project value, for example as stated in a feasibility study)
- Contract price method (the transaction price agreed between buyer and seller)

<u>Exploration Licenses</u>
In the case of a transfer between unrelated parties, the value of the license will be computed based on the contract price as reported by the taxpayer. However, if the contract price is lower by 20% or more than the value computed using the below method, the value of the license will be determined by the License Valuation Regulations:
- In the event that the reserves associated with the license have been categorized as A or B by the Minerals Council, then the income-based method will be applied;
- In the event that the exploration expenditures incurred by the license holder do not exceed total of the minimum exploration expenditures prescribed by the Minerals Act by the percentages set out in the act, the average of the value computed using the market-based method and the cost-based method will apply;
- In all other cases, the cost-based method will be applied. To the best of our knowledge there is a large degree of flexibility regarding what costs can be potentially included.

<u>Mining Licenses</u>
In the case of a transfer between unrelated parties, the value of the license will be computed based on the contract price as reported by the taxpayer. However, in the event of the contract price is lower by 20% or more than the value computed using the income-based method, the income-based method will be applied. In the event that it is not feasible to apply the income-based method, then the cost-based method will be applied.

General Observations of the Application of the ITTR
- For transfers of mineral licenses, both exploration and mining licenses, the Mongolian Tax Authority ("**MTA**") has the right to value the licenses according to their own valuation methods, they are not required to use the purchase price.
- Taxing a transaction by applying a valuation methodology that is not the transfer price inevitably means that there is high chance that there will be a difference in the transaction valuation applied by the MTA, and the actual valuation agreed between buyer and seller.
- As tax is applied to the valuation, this can lead to distortions in the taxes that are levied on a transaction.
- The MTA is not in a passive role in their application of their own valuations of mineral assets. The MTA is not restricted to checking on unusual valuations, the MTA is in an active role, they have the legal right to apply their own valuation. They do not have to alter their own valuation, even if

provided with conclusive evidence that the price agreed between buyer and seller is the actual price of the transaction.

- To the best of our knowledge, this method of valuation by the MTA is not in line with tax policies for the transfer of mineral licenses in other countries. We are not aware of other types of assets in Mongolia for which the MTA can apply their own valuation method.

The methods applied by the MTA in the transfer of mineral licenses are not applied if the transfer price is above the valuations using the alternative methods, they only apply if the transfer price is below the other methods. This leads to an obvious conclusion, if firms have been successful in Mongolia in mining and exploration and can sell their licenses at a profit, they may be taxed fairly. However, if they have lost money, taxes will be disproportionately high. In other words, they will be punished by the MTA for their lack of successin their exploration or mining activities.

Problems with Historical Cost Methodology

It is well known that exploration and mining activities carry high risk. These risks are due to factors both within and beyond the control of mining and exploration companies.

High risk, means that there is a high chance that the business may be unable to recover the capital invested. Generally early-stage activities such as exploration are higher risk than later stage activities, such as mining. However, both exploration and mining are often considered high risk activities.

Risk is not only associated with the business, but with valuation of assets, including mining and exploration assets. Valuations are volatile. At times, valuation of mining or exploration assets may be very high, regardless of their profitability, and at times valuations could be low, even for profitable enterprises. The volatility of commodity prices and the prices of mining and exploration company stock prices traded on exchanges is evidence of the volatility of assets valuations. The MTA's fixed valuation methodologies will never consider all of the factors that contribute to a buyer and a seller agreeing on a market-based valuation.

The current historical cost methodology assumes that if a business puts money into exploration, they will, at a minimum, get all of that money back if they sell the license. Such a business would be a risk-free business. Clearly this assumption is not applicable to any business, and certainly not to the exploration business.

Problems with valuing a mining license at the project value as stated on the feasibility study

It is common for mining companies to trade at significant variations, both premium and discounts, to the valueof the project as stated on a feasibility study. However, it is more common for the valuation of a mining company to trade at a discount than at a premium. A study of mining companies listed on overseas exchanges would reveal this valuation disconnect.

Often feasibility study valuations are optimistic, for promotional purposes. Often the discount rate used is lower than the actual cost of capital of the company to inflate the project value.

Additionally, there is always the timing of a valuation. Mining businesses are affected by multiple issues such as operational issues, the price of commodities on global markets and other factors. These factors affect the value of a mining business on a day-to-day basis, a valuation on a feasibility study may be outdated very soon after the valuation date.

For these reasons, mining is a complex and risky business and not all miners are able to sell their mining licenses at the amount originally predicted in the feasibility study, they may also be unable to recover their costs.

2. Deductibles in the ITTR

Current Law

Deductible costs include the cost of acquisition of the license, meaning; (a) payments made to the Government for acquiring and holding the license and (b) payments made to purchase the license if it was purchased from the previous holder of the license. Other costs, for example costs of exploration, are not deductible.

Problems with Limited Deductibles

The omission of other deductibles, in particular the costs of exploration, means for practical purposes, that themost significant costs cannot be deducted. The result of this is that the ITTR functions more like a gross rather than a net tax.

Most taxes are net taxes. It is generally considered more reasonable to tax profit making companies than loss making companies. As previously mentioned in this paper, mining and exploration are high risk activities and it is reasonably expected that some companies will incur losses.

It is noted that the ITTR is not the only tax that applies to the sales of shares. Profit on a sale of shares constitutes taxable income in Mongolia, both for companies and individuals, and where such entities or individuals are non-resident for tax purposes, withholding taxes apply.

Summary

EuroChamber Mongolia supports the development of a tax regime that will provide clarity, be equitable and encourage investment in the exploration and mining sectors.

The arguments against the valuation methodology in the ITTR are not limited to the arguments outlined above. There is generally clarity in the valuation methodologies used for mineral asset valuations, meaning the methodology is adequately stated. The key problem is that the valuation methods used cause valuation distortions, leading to an unfair rate of tax levied, as evidenced in a significant number of transactions.

Recommendation on valuation of mineral license transfers. The MTA should use the sale / purchase price to value mineral license transfers. The MTA should not have rights to apply their own methodology for the valuation of mineral license transfers.

Recommendation on deductibles for the ITTR. Deductibles for the ITTR should follow general tax rules, rather than specific restrictive rules for the ITTR.