Taxation and Financial Reporting

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Motivation

At the request of the MMHI, this study will focus on the following question related to tax incentives:

- What are the experiences in other countries?
- How do countries approach formulating these incentives?
- Is there a need for Mongolia to promote the mining sector through tax incentives?
- What are the possibilities for Mongolia to implement tax incentives?

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Overview of taxation in Mining: Mining Incentives and Royalties

Taxation in Mining

Objectives of taxation in mining sector (NRGI)

- Maximizing the economic return to the state from its resource endowment
- Sharing risks and expected returns between the state and the investor
- Consistency with national development context and strategy
- Ease of administration and compliance

Taxation instruments in resource sector

- Fixed fees (license fees, signature bonuses) – not dependent on factors such as project scale, profitability or quantity or value of production.
- Per-unit charges (Royalties, Import tariffs, VAT, Land rents, Property taxes) – based on the flow of a good or service.
- Shares of measured profits (Profit taxes, dividends, profit shares, production sharing arrangements, resource rent taxes, windfall taxes) -based on a proportion of revenues minus cost.

Mining Incentives: International Practices

- Income tax incentives
- Income tax holidays
- Withholding tax relief
- Cost-based incentives
  - Accelerated deprecation
  - Investment allowances
  - Investment credits
  - Loss carry forward
- Import and export taxes (incentives in special economic zones)

Mining Incentives: International Practices

Chile:

- CIT rate 24%
- Withholding tax 35%
  - Accelerated depreciation and cumulative losses
  - Deductions for interest payments encourages debt financing for large capital

Peru:

- Royalty on “operating profits”
- Special mining tax
- Special mining contribution
- Fees (such as good standing fees that must be paid on the mining area) are deducted from taxes
- Losses can be carried forward for up to 4 consecutive years following the loss (limited to 50% of taxable income)
- Mining companies can finance local investment projects in exchange for tax certificates (used to pay CIT)

Mining Incentives: International Practices

Australia:

- Mineral resource rent tax 22.5% (effective)
- Mineral resource rent tax was repealed in 1st October 2014
- Exploration expenditure is deductible for income tax
- Exploration development incentive allows to convert income tax losses arising from exploration expenditure, into a refundable tax offset or additional franking credits that can be passed on to shareholders
- Fuel excise tax exemptions (mainly diesel)
  - Awarded the mining sector 2.5 billion AUD in fuel tax credits in 2018
  - Fuel excise tax is normally 40.1 cents a liter for liquid fuels such as diesel
- Environmental rehabilitation costs are income tax deductible

Canada

- Exploration expenditure is deductible for income tax
- Territories have individual exploration inventive programs to provide funding for companies continuing or beginning new exploration projects

Mining Incentives: International Practices

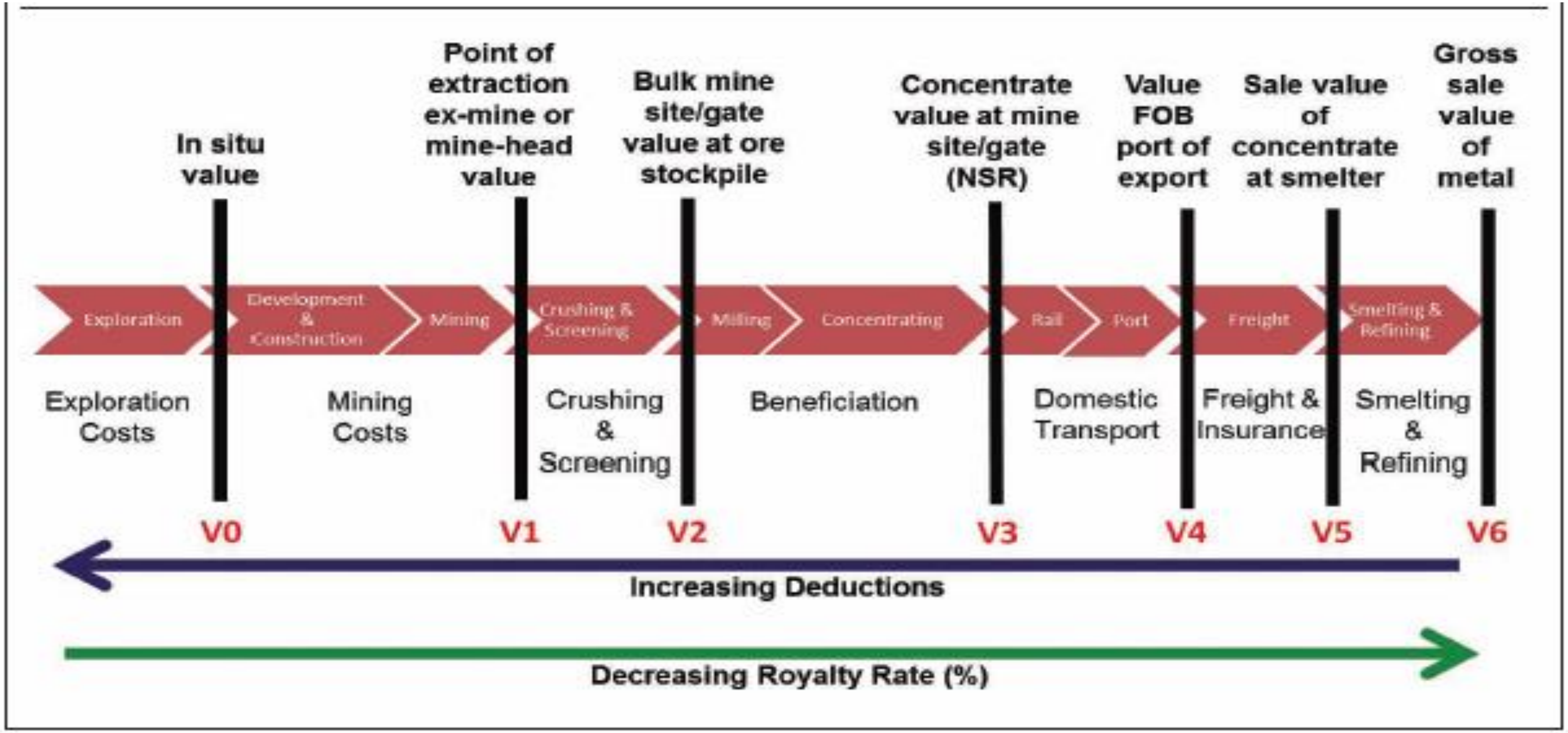
Tanzania:

- As of 2012, No import duties on mining related equipment (until the end of the first year of production)
- No import duties on fuel
- No capital gains tax
- Special VAT relief (no VAT on imports and local supplies of goods and services to mining companies and their subcontractors)
- Lower stamp tax (0.5% as compared to 4%)
- Maximum local tax payment of $200,000 (instead of 0.3% of turnover)

Mixed results:

- 2011 IMF report: Below potential tax revenues
- Gold exports grew from 500 million USD to 1.5 billion USD from 2015-2010
- Tax revenue from gold companies stayed consistent at 100 million USD
    - This is from royalties and taxes on wages
    - Due to tax holidays, gold companies haven't paid CIT

Royalties


In situ value
Point of extraction ex-mine or mine-head value
Bulk mine site/gate value at ore stockpile
Concentrate value at mine site/gate (NSR)
Value FOB port of export
Sale value of concentrate at smelter
Gross sale value of metal
Exploration
Development & Construction
Mining
Crushing & Screening
Milling
Concentrating
Rail
Port
Freight
Smelting & Refining
Exploration Costs
Mining Costs
Crushing & Screening
Beneficiation
Domestic Transport
Freight & Insurance
Smelting & Refining
V0
V1
V2
V3
V4
V5
V6
Increasing Deductions
Decreasing Royalty Rate (%)

Types of royalties

- *Unit based (specific royalty)*

  A fixed monetary value is levied on a physical measure of volume or weight of the mineral produced and sold rather than the financial base. Provisions may be incorporated in the regulation for progressive adjustments of the fixed royalty rate to inflation or to changes in commodity prices. This type of royalty generates stable revenue and is administratively efficient and easy to audit. However, it can also be highly economically inefficient and distortionary. For these reasons, specific royalties are generally applied to bulk, low-value commodities.

- *Value based (ad valorem) royalty*

  a uniform percentage of royalty charged on a value of minerals sold by the miner. As a value-based royalty is implemented, valuation point or the royalty base should as close as possible to the point of mineral extraction or prior to the any processing. However, the sales of minerals usually don't occur at the mine gate. Sales occur often after some value added by downstream process such as packaging, and transporting. Thus, the royalties are charged on sales value rather than the value at the mine gates.

Types of royalties

- *Profit-based royalty*

  On the basis of accounting concept of net income or profits of a given mining project. The royalty rate is often set as a result of negotiation between government and miners. This type of royalty is economically more efficient than the previous two types royalties both for governments and miners, yet, it is more complicated to administer and is usually followed by many disputes related to the accounting of the profits. Clear and transparent legislation is necessary in order to implement the royalty regime successfully.

Calculating Royalties: International Practices

South Africa (Mineral and Petroleum Resources Royalty Act)

Unrefined minerals is:

$$Y(u) = 0.5 + \{EBIT / Gross\ Sales \times 9)\} \times 100$$

Y(u) = royalty percentage unrefined; EBIT = Earnings before interest and taxes (but EBIT can never go below zero)

The minimum and maximum: 0.5% and the maximum royalty percentage is 7%

Refined minerals is:

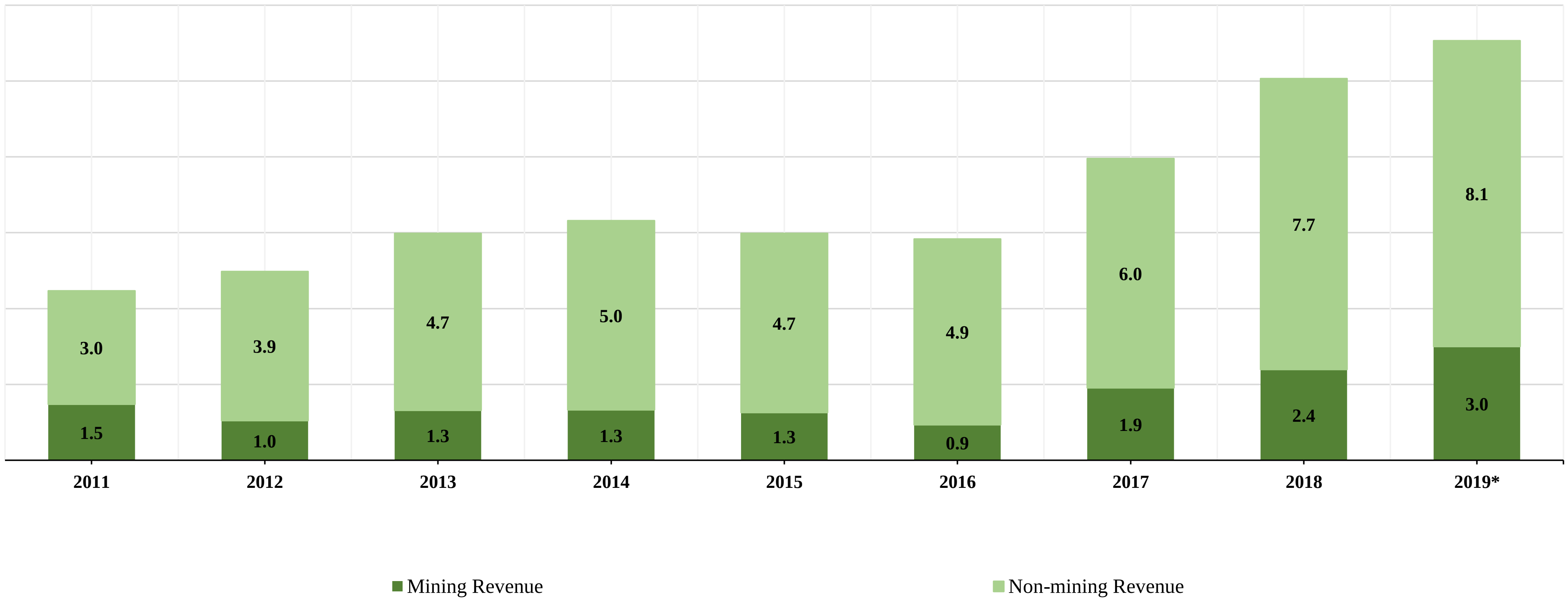
$$Y(r) = 0.5 + \{EBIT / Gross\ sale \times 12.5)\} \times 100$$

Y(r) = Royalty percentage refined; EBIT = Earnings before interest and taxes (but EBIT can never go below zero)

The minimum and maximum: 0.5% and the maximum royalty percentage is 5%

Overview of Mining Taxation: Mongolia

Mining and Non-Mining Revenue in Mongolia



Corporate income tax in Mongolia

Name of taxes and charges	Rate	Note
Corporate Income Tax (CIT)	• 10% for annual taxable income of MNT 0- 3 billion • 300 million MNT plus 25% for annual taxable income of exceeding 3 billion MNT	
Value Added Tax (VAT)	• 10% on sales value of all minerals produced or sold	Exemption: – Crude oil and its articles – Final Mineral Products – Sales of gold

Withholding taxes in Mongolia

Withholding taxes on:

- dividends
- Interest
- royalties paid
- payments made for goods sold and services provided

- 10% on payments to residences
- 20% on payments to non-residences

Exemption: A sales income of produced crude oil, which is allocated to the entity who produces crude oil in the territory of Mongolia under the production sharing agreement

Royalties in Mongolia

Minerals type	Benchmark Rate	Additional rate
Coal	– In domestic market, royalty of 2.5% is levied based on its sales value. – For export, royalty rate is 5%.	– Raw coal: As the benchmark price exceeds 25 USD per ton, 1% marginal rate is applied on every marginal increase 25USD of price Concentrated coal: As the benchmark price exceeds 100 USD per ton, 0.5% additional rate is applied on every marginal increase of 30USD of price
Gold sold to Bank of Mongolia or its representative banks	– 2.5% of sales value Benchmark price: Gold price announced by BoM	– Only if the gold is sold as final product, if thebenchmark price exceed 900 USD per ton, additional 0-5% royalty is levied on per ounce of golden product
Copper	– 5% of sales value Benchmark price: Copper price announced by LME – 5% of sales value	– If the benchmark market price exceeds USD 5000 per ton, 22-30% (a 2% marginal rate of each exceed of USD 1000 of additional royalty is levied on per ton of copper ore – 11-15% of additional royalty on per ton of copper concentrate – 1-5% of additional royalty on per ton of final copper product
Other Minerals		**If the benchmark price exceeds certain level of price, additional royalty rates of ranging from 0.5% to 5% are levied on the per ton or minerals depending on the market price.**

State participation in Mongolia

Mines	Minerals type	Ownership	
Tavan Tolgoi	Coal	Erdenes Tavan Tolgoi Tavantolgoi LLC	Estimated Resources: 6.5 billion tons of coal
Nariin Sukhait	Coal	Mongolyn Alt Corporation LLC, (57%) Mongolian-Chinese Qinhua-MAK-Nariin Sukhait LLC, South Gobi Energy (43%)	380 million tons of coal
Baganuur	Thermal coal		
Shivee-Ovoo	Thermal coal		
Erdenet	Copper, Molybdenum		
Oyu Tolgoi	Copper, Molybdenum	Erdenes Oyu Tolgoi (34%) Turquoise Hill (66%) Indirectly owned by Rio Tinto	Stabilization clause

Are there incentives in Mongolia? Mining Taxation and Corporate Income Tax

Extractive Industry Transparency Intitative (EITI) - 2,240.6 billion MNT (30.9%) revenue to the government in 2017

Total equilibrated revenue and grants of the Mongolia government was 7,239 billion MNT in 2017

Corporate Income Tax

- 10% income tax for profits below 3 billion MNT and or a payment of 300 million MNT
- 25% income tax on any income above 3 billion MNT
- No special income taxes or incentives for companies operating in the mining sector

Are there incentives in Mongolia?
Tax Stabilization

Investment amount (billion MNT)	Stabilisation certificate terms (years)					Investment Period (Years)
	Ulaanbaatar Region	Central Region	Khangai Region	Eastern Region	Western Region	
30 to 100	5	6	6	7	8	2
100 to 300	8	9	9	10	11	3
300 to 500	10	11	11	12	13	4
more than 500	15	16	16	17	18	

Can incentives work for Mongolia?

Klemm et.al. (2012) argue that it is largely dependent on the level of institutional quality

Mongolia's institutional quality is weak

- "Ease of Doing Business" by World Bank, Mongolia ranked 74th out of 194 countries
- 126th according to "Economic Freedom Index" by Heritage Foundation
- Investment attractiveness, Mongolia ranked 81st out 104 countries in 2016 by Frazier Institute
- Frazier Institute's policy perception index, Mongolia ranks 101st out of 104 countries

However, the country's mineral potential is ranked at 50th out of 104 countries so this is not a problem

Can incentives work for Mongolia?

- Mongolia’s tax challenges are not as pronounced as those in Kyrgyz Republic or other similar countries. Tax regime’s effective tax rate constitutes between 50 to 60 percent (Indonesia Chile Kazakhstan Kyrgyz)

- Political and policy stability is the main concern for investors

- We also argue that although there is a room for tax incentives, given the quality of institutions it is not the primary contributor

Can incentives work for Mongolia?

- The country’s tax burden is not low
- But, the stability of policies and improvement of business environment in the country will be rather detrimental in incentivizing the investment in the mining sector
- Policy should focus more on improving business environment
- Stability of policies should be of paramount importance

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Thank you