

Transfer Pricing – Concept Introduction

General Department of Taxation (GDT) on 24 December 2015 issued the Decree No 353 of the Minister for Finance, procedure for determining the “Transfer Price”.

Decree No. 353 regarding guidelines for determining transfer pricing of taxpayers with special relationships. Purpose of this Procedure is to regulate the relations connected to the determination of “Transfer Price” in order to comply with the Article 48 of the General Tax Law, and Articles 6 and 11 of the Corporate Income Tax Law.

Mongolian's transfer pricing rules seek to avoid the underpayment of tax in Mongolia by having businesses price related party overseas or domestic dealings according to what is expected from independent parties in the same situation.

Pricing for overseas or domestic dealings between related parties should reflect the right return for the activities carried out in Mongolia, the Mongolian assets used (whether sold, lent or licensed), and the risks assumed in carrying out these activities.

You should carefully consider terms and conditions of any overseas or domestic dealings with related parties to ensure your business outcomes properly reflect economic activity in Mongolia.

Mongolian's double tax agreements and domestic law require pricing of goods, works and services and allocation of income and expenses between related parties to accord with the arm's length principle.

The arm's length principle

These Transfer Pricing procedures are largely based on the governing standard for transfer pricing which is the arm's length principle as set out under the Organization for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines. Although some parts of the procedures have been adopted directly from the OECD Transfer Pricing Guidelines, there may be areas which differ to ensure adherence to the General Tax law and Corporate Income Tax law procedures as well as domestic circumstances.

The arm's length principle uses the behavior of independent parties as a guide or benchmark to determine the pricing of goods, works and services and how income and expenses are allocated in overseas or domestic dealings between related parties. It involves comparing what a business has done and what an independent party would have done in the same or similar circumstances.

As many factors may influence prices or margins, you need to closely examine the dealings you are comparing and the circumstances of the parties involved. This comparison with arm's length activity means it is difficult to achieve absolute precision and certainty. For dealings to be comparable, none of the differences between the situations should be material, or reasonably accurate adjustments can be made to eliminate the effect of any such differences. The materiality of any differences depends on examining the facts and circumstances of each case and recognizing there is likely to be some uncertainty in the judgments that have to be made.

Meaning of control and associated

Article 6 of the Corporate Income tax law refers to “control” as both direct and indirect control. The interpretation of related companies or companies in the same group (referred to in the context of holding and subsidiary companies) is provided for under article 48 of the General Tax Law and article 10 of the Personal Income Tax law.

Under the procedures, two companies are associated companies with respect to each other if one of the companies participates directly or indirectly in the management, control or capital of the other company; or the same persons participate directly or indirectly in the management, control or capital of both companies.

Transfer pricing methodologies

The following methodologies can be used in determining arm’s length price:

- i. Comparable uncontrolled price method
- ii. Resale price method
- iii. Cost plus method
- iv. Profit split method
- v. Transactional net margin method

The first three methods are commonly known as “traditional transactional methods”. Although the taxpayer is given the right to choose any method, the emphasis should be on arriving at an arm’s length price. It is advised that methods (iv) and (v), commonly referred to as “transactional profit methods”, be used only when traditional transactional methods cannot be reliably applied or exceptionally cannot be applied at all. This will depend heavily on the availability of comparable data.

Documentation requirements

You should adequately document compliance with the arm's length principle, in order to reduce the risk of audit by, and dispute with us, to help explain your position to us, to minimize penalties in the event of an audit adjustment, as any penalties will have regard to the extent and quality of the documentation kept.

Types of controlled transactions may involve:

- a. Sales or purchases of raw materials, stock in trade or other tangible assets;
- b. Royalties / license fees / other types of considerations in connection with use of intangible assets;
- c. Management fees including charges for financial, administrative, marketing and training services;
- d. Research and development;
- e. Any other services not previously mentioned;
- f. Rents / lease of assets;
- g. Interests; or
- h. Guarantee fees.

Submission of Transfer Pricing Documentation

Transfer pricing documentation should be made available to the GDT within 20

days upon request.

List of documentations

A transfer pricing documentation may consist of the following:

(a) Organizational Structure

(i) Taxpayer's worldwide organizational and ownership structure (including global organization chart and significant changes in the relationship, if any), covering all associated persons whose transactions directly or indirectly affect the pricing of the documented transactions.

(ii) Company organization chart.

(b) Group financial report

Transfer pricing documentation should include the group financial report, equivalent to an annual report, for the most recent accounting period.

(c) Nature of the business/industry and market conditions

(i) Outline of the taxpayer's business including relevant recent history, the industries operated in, analysis of the general economic and legal issues affecting the business and industry, the taxpayer's business lines and the property or services in the controlled transactions;

(ii) The corporate business plans to the extent of providing an insight into the nature and purpose of the relevant transactions between the associated persons;

(iii) A description of the structure, intensity and dynamics of the relevant competitive environment(s).

(d) Controlled transactions

(i) Description of details of the property or services to which the international/domestic transaction relates; any intangible rights or property attached thereto, the participants, the scope, timing, frequency, type and value of the controlled transactions (including all relevant related party dealings in relevant geographic markets);

(ii) Names and addresses of all associated persons, with details of the relationship with each such associated person;

(iii) The nature, terms (including prices) and conditions of international transactions (where applicable) entered into with each associated person and the quantum and value of each transaction;

(iv) An overview description of the business, as well as a functional analysis of all associated persons with whom the taxpayer has transacted;

(v) All commercial agreements setting forth the terms and conditions of transactions with associated persons as well as with third parties;

(vi) A record of any forecasts, budgets or any other financial estimates prepared by the person for the business as a whole and for each division or product separately.

(e) Pricing policies.

(f) Assumption, strategies and information regarding factors that influenced the setting of pricing policies

(i) Relevant information regarding business strategies and special

circumstances at issue, for example, intentional set-off transactions, market share strategies, distribution channel selection and management strategies that influenced the determination of transfer prices;

(ii) Assumptions and information regarding factors that influenced the setting of prices or the establishment of any pricing policies for the taxpayer and the related party group as a whole;

(iii) Documentation to support material factors that could affect prices or profits in arm's length dealings.

(g) Comparability, functional and risk analysis

(i) A description of the characteristics of the property or service transferred, functions performed, assets employed, risks assumed, terms and conditions of the contract, business strategies pursued, economic circumstances and any other special circumstances.

(ii) Information on functions performed (taking into account assets used and risks assumed) of the related party involved in the controlled transaction as well as a description of group of companies to the extent that they affect or are affected by the controlled transactions carried out by the taxpayer.