

Chapter 5

5 Items Requiring Amendments in the Corporation Tax Law

5.1 Creation of Corporate Business Tax System

The Study Team holds the view that those companies operating at a deficit, who receive the communal benefits of taxation without bearing any of its burden, should be required to bear their appropriate share of the tax burden. Accordingly, we have proposed the introduction of the Corporate Business Tax System, which would be a continuous source of fiscal revenues.

The corporate tax is a type of taxation based on the size of the enterprise. From the point of view of full coverage of deficit-ridden enterprises, it would be appropriate to have a flat tax of 100,000 Tg levied to whole enterprises; accordingly, the basic tax amount for the corporate tax would be the greater of 100,000 Tg or the tax amount calculated based on sales or gross payroll. In essence, the easiest method of taxation is the best method of taxation and obviously such a method leads to a reduction in the administrative burden on the tax office staff and a result leading to a reduction in the cost of tax administration.

In case of a large enterprise with sales in excess of 10 million Tg, for example, the tax levied will be subject to greater of 3% of the sales amount or 5% of gross payroll. In case of small and medium-sized enterprises with sales of less than 10 million Tg, the income will be taxed at greater of 3% of sales or 100,000 Tg. The application of this method will contribute to reduce tax burden on the small and medium sized enterprises. In either case, the corporate tax will be ultimately determined at the greater of this fixed Corporate Business Tax amount or the reported corporate taxes for the year.

If strong objections from the taxpayers are expected with regard to the introduction of such a system, measures can be taken such as reducing the applicable tax rates. While it may result in making the initial tax revenues small, this system must be created and introduced immediately in order to lay the foundation for the future efforts for fiscal revenue enhancements.

By adopting this system, as stated in the beginning, even those enterprises with deficits will be required to bear certain level of tax burden. As a result, it would lead to a sustained increase in the corporate tax revenues.

<Reference : Estimated incremental fiscal revenue>

If a 3% tax were to be levied based on the 1999 corporate tax revenue amount, the estimated Corporate Business Tax amount would be as follows:

Assume: Number of registered enterprises in 1999 of 16,320 with number submitting tax returns of 14,354

- (i) 1999 Gross corporate sales revenues: 891,436,847,480 Tg
- (ii) 1999 Gross enterprise payroll: 99,835,384,220 Tg
- (iii) 1999 Gross corporate taxes: 24,633,341,000 Tg
- (iv) 3% of gross sales = (i) x 3% = 26,743,105,424 Tg
- (v) Corporate Business Tax = (iv) – (iii) = 2,109,764,424 Tg
- (vi) Net incremental Corporate Business Tax :[(16,320 – 14,354) x 100,000 Tg]
= 196,600,000 Tg
- (vii) Corporate Business Tax based on 100,000 Tg being levied: (16,320 x 100,000 Tg)
= 1,632,000,000 Tg

Based on the above calculation formula, the Corporate Business Tax based on 1999 figures would be the sum of (v) and (vi) or 2,306,364,424 Tg.

Chapter 6

6 Items Requiring Amendments in the Individual Income Tax Law

6.1 State of the Individual Income Tax

Shown below are individual income taxes collected in the three-year period from 1997 through 1999 and its share of total fiscal revenue and its breakdown.

Table 6-1 Individual Income Tax Revenue (Unit: 1,000 Tg)

	1999	1998	1997
(i) Total Fiscal Revenues	123,176,204	103,305,112	115,040,583
(ii) Individual Income Tax	12,564,271	9,954,158	7,703,386
(ii)/(i)	10.2%	9.6%	6.7%
(Number of people registered)	229,292 (100%)	76,925 (100%)	79,458 (100%)
(Number of filings)	20,114 (8.8%)	13,849 (18.0%)	4,176 (5.3%)

Table 6-2 Breakdown of Individual Income Tax (Unit: 1,000 Tg)

	1999	1998	1997
Withholding from wages	10,544,329 (83.9%)	8,129,366 (81.7%)	6,709,478 (87.1%)
Patent **	1,014,911 (8.1%)	849,670 (8.5%)	291,242 (3.8%)
Livestock	693,329 (5.5%)	588,316 (5.9%)	438,741 (5.7%)
Self-Employed	289,913 (2.3%)	233,044 (2.4%)	130,644 (1.7%)
Other Withholdings	21,790 (0.2%)	153,762 (1.5%)	-
Interest from Deposits	-	-	133,281 (1.7%)

* % in brackets represents proportion of individual income tax in Table 6-1 (ii).

** Patent is the tax imposed based on the standard tax amount against those who are self-employed specified under "Income Tax Law for Self-employed Persons Engaged in Businesses and Services with Indefinite Incomes".

As can be seen from Table 6-1, although the proportion of individual income tax in the total fiscal revenues has been increasing, reaching 10.2% in the previous year, in comparison with VAT (27%) or corporate income tax (20%), it is relatively at a lower level. In Japan, for example, in the general account budget for 1999, individual income tax (including both taxes withheld from wages and reported income taxes) represented 38.4% of the total tax revenues, while the consumption tax and the corporate income tax represented 20.3% and 20.4% respectively.

Referring to Table6-2, if we do a similar analysis of the breakdown of income taxes using the actual results of 1999, taxes withheld from wages represented an overwhelming 83.9% of the total amount followed by fixed Patent tax paid by the self-employed representing 8.1%, tax levied on ownership of livestock representing 5.5%, other taxes paid by the self-employed representing 2.3% and other category 0.2%.

The proportion of other taxes to individual income taxes, particularly income taxes on income other than wages, is relatively low. Also, the number of tax return filings is low relative to the number of registered taxpayers (8.8% in 1999). The issue is whether this is due to the large numbers who do not need to file tax returns because of low income levels that otherwise would be subject to taxation, or due to issues or problems that exist in the system or the execution of taxation or collection that are preventing the realization of what ought to be larger tax revenues. The Individual Income Tax Law issues involving the system and execution will be further examined from several perspectives.

6.2 Composition of the Individual Income Tax Law

The Individual Income Tax Law was introduced in 1993 and has gone through several revisions to compose the existing law and is made up of 12 Articles.

6.2.1 Income Subject to Taxation

With regard to incomes to be taxed within each Article, it defines specifically the source of such income. In addition to providing for exemption of a specified portion of income from taxation (Article 9 Clause 1), it defines “incomes other than incomes exempted under this Law” (Article 4 Clause 1.9), thus the interpretation is that all economic profits are in principle subject to taxation.

With respect to this point, although it differs from the Japanese Income Tax Law in which the withholdings are clearly categorized into 10 categories according to the tax bearing capacity and the methodology for the calculation of taxable income are established for each category, it shares similarity in that it envelops all economic profits as being subject to taxation.

6.2.2 Method of Calculation of Taxes to be Paid and Classification According to the Method of Payment

As for the method of payment, two methods are being employed:

- (a) Self-assessment system in which the taxpayer, himself, calculates the taxable income by deducting from income for each calendar year necessary expenses and filing an income tax return and paying the tax amount calculated by application of the basic tax rate (Article 7 Clause1) (includes cases in which the taxes are withheld at the time of receiving compensation but settled at year-end and reported the following year), and
- (b) Withholding tax system in which a special tax rate (each item in Article 8) is

applied to calculate the tax amount and such tax amount being withheld from payments to consummate the tax payments.

Further, in order to smooth out the revenue stream, even for the self-assessment described above in (a), taxes are calculated and paid monthly or quarterly with a final settlement taking place each year-end.

If the incomes that are subject to taxation were classified according to the method of calculation and payment of taxes, it would be as follows:

(1) Incomes to which Basic Tax Rate (progressive taxation of 15% and 40%) are applied and reported in tax returns.

- 1) Salaries and wages earned from a principal occupation based on a labor contract with a judicial person (Article 4 Clause 1.1.(a))

The employer shall withhold taxes each month and pay such taxes by the tenth of the following month. Such taxes will be settled at year-end and annual tax returns filed with the tax administration by 10th of February of the following year.

- 2) Salaries or wages earned as a result of labor contracts with judicial persons, individuals other than those of taxpayer's principal occupation (Article 4 Clause 1.1 (b))

A 10% withholding will be made at the time of payment but year-end settlement and the annual tax return are the same as in 1).

- 3) Annuities and supplemental annuities (Article 4 Clause 1.1 (c))

Year-end settlement and the annual tax return are the same as in 1).

- 4) Income derived from self-employment (Article 4 Clause 1.3)

Taxable income is calculated by deducting from income various expenses including the cost of raw materials and tax is calculated each quarter, to be paid by the 15th of the first month after the closing of the quarter. Year-end settlement

and the annual tax return are the same as in 1).

Further, taxable income for farmers engaged in pig farming, poultry farming, rabbit farming, apiculture or other similar forms of farming shall be calculated by the taxpayer in accordance with this Article (Article 5 Item 2 (c)).

- 5) Income earned by an individual from the sales of products and materials to a judicial person (Article 4 Clause 1.4)

When a self-employed individual sells products or materials to a judicial person, the judicial person must withhold an amount equal to 3% of the purchase price as income tax. The income tax withheld shall be settled during the process of calculating the taxable income and the taxation amount as a self-employed person at the year-end settlement. In addition, an income tax report needs to be filed with the tax administration in the following year.

- 6) Income derived from rental of assets (Article 4 Clause 1.5 (c))

Taxable income is calculated by deducting associated expenses from the income and the tax amounts will be calculated each quarter and be paid by the 15th of the first month following the closing of the quarter. Year-end settlement and the annual tax return are the same as in 1).

- 7) Income other than income exempted under this Law (Article 4 Clause 1.9)

Taxable income will be the received income. Year-end settlement and the annual tax return are the same as in (a).

(2) Incomes for which taxation is consummated by withholding income taxes calculated by application of a special tax rate (2%, 10%, 15%).

- 1) Income from sales of real estate and other similar income (Article 4 Clause 1.5 (a))

Taxable income is the revenue from the sale of the real estate (Article 5 Item 3 (a)). The tax is calculated by applying a special rate of 2% (Article 8 Item 3) which shall be paid by the 15th of the following month after the close of the quarter (Article 10 Item 4). In addition, a tax return shall be filed with the tax

administration within 15 days of the payment of taxes.

2) Dividends and shareholder profit (Article 4 Clause 1.5 (b))

Taxable income shall be the income associated with the profits (Article 5 Item 3 (d)). An income tax calculated by application of a special tax rate of 15% to the taxable income (Article 8 Item 4) shall be withheld and paid into the budget within 3 days (Article 10 Clause 6). Annual or quarterly income tax returns shall be filed with a tax administration within 15 days of the payment of the income (Article 11 Clause 5).

However, taxation on dividends and stock holder profits is to be implemented starting January.

3) Income from royalties for copyright, software, patents and etc. (Article 4 Clause 1.5 (d))

Taxable income is the income associated with the royalty (Article 5 Item 3 (f)). A special tax rate of 10% shall be applied to calculate the income tax and such amounts shall be withheld and paid into the budget within 3 days (Article 10 Clause 6).

4) Interest income derived from loans and bank deposits (Article 4 Clause 1.5 (e))

Taxable income shall be the income associated with the interest amount (Article 5 Clause 3 (e)). A special tax rate of 15% (Article 8 Item 4) shall be applied to calculate the income tax and such tax shall be withheld and paid into the budget within 3 days (Article 10 Clause 6).

However, taxation on interest income from loans and bank deposits will be implemented starting January 1 2003.

5) Compensation for Science, Arts, Author of Artistic Works, Inventor or Technical Innovator, Architect or Designer or other similar incomes (Article 4 Clause 1.6)

Taxable income shall be the income received (Article 5 Item 5). A special tax rate of 15% shall be applied (Article 8 Item 1) to calculate the income tax and such tax shall be withheld and paid into the budget within 3 days (Article 10

Clause 5).

6) Prize money from sports and entertainment business (Article 4 Clause 1.7)

Taxable income shall be the income received (Article 5 Item 6). A special tax rate of 10% (Article 8 Item 7) shall be applied to calculate the income tax and such tax shall be withheld and paid into the budget within 3 days (Article 10 Item 5).

7) Winnings from gaming, quiz and lottery (Article 4 Clause 1.8)

Taxable income shall be the income received (Article 5 Item 7). A special tax rate of 10% (Article 8 Item 7) shall be applied to calculate the income tax and such tax shall be withheld and be paid into the budget within 3 days (Article 11 Clause 5).

8) In cases of taxation on income derived overseas from the provision of medical, cultural, academic research, advertisement and other intellectual services which is not specifically defined under this Law or under any other international agreements entered into by Mongolia (Article 8 Item 9), 10% income tax shall be withheld and be paid into the budget within 3 days (Article 11 Clause 5).

9) If the taxpayer has not notified his employer of his taxpayer registration number (Article 8 Item 10)

Apply the special tax rate of 20% for Article 8 Items 1, 4, 6, 7 and 8 as provided for in Article 8 **.

10) Short-term visitor (foreigners and stateless persons who stay in Mongolia for a period of less than 183 days in any one year) and non-residents (those who stay in Mongolia for a period longer than 183 days in any one year other than permanent resident taxpayer and short-term visitors) (Article 8**)

For income defined under Article 4 Clause 1.5 (c) "Income from Rental of Assets" and Article 8 "Compensation other than Items 1, 3, and 9", a special tax rate of 20% shall be applied.

(3) Taxable Income from Livestock (Article 6)

Taxable income of a livestock farmer shall be computed by conversion of livestock count to heads of sheep. For the purposes of computation of taxable income, cattle, horses and camels shall be converted each into 5 heads of sheep while a goat will be converted into 1.5 heads of sheep. Livestock count subject to taxation for the livestock farmer for the budget year shall be determined based on the yearend livestock count of the previous year. Amount of taxation to be applied to the headcount of sheep shall be determined by subdividing into 3 districts (Article 8 Item 5).

**(4) Income Associated with Businesses or Services with Indefinite Income
(Article 7 Clause 4)**

Taxation process to be applied to self-employed persons engaged in businesses that are subject to indefinite incomes shall be determined by the National Assembly based upon proposals presented to it by the government.

Under this provision, "Income Tax Law for Self-employed Persons Engaged in Businesses and Services with Indeterminable Income" was enacted and came into effect on May 1, 1997. Self-employed persons subject to this Law will have consummated his/her tax obligation by paying a flat amount each month determined according to industry and region without regard for his business revenues or expenses (Patent).

Further, separately from this, under Article 5 of this Law, there is a provision "If the taxable income is not determined or unable to be determined, the tax administration shall determine tax amounts by making comparison with business or produce of similar natural, climatic and market conditions" providing for presumptive taxation or standard taxation.

The concept of taxable income, method of taxable income calculation and method of tax payment under the existing Individual Income Tax Law have been discussed above. Next, an examination of issues involving the system and its execution shall be made.

6.3 Issues Involving the System and Execution in the Individual Income Tax Law

6.3.1 Taxation for Businesses and Services with Indefinite Income

Of those self-employed or those who are engaged in businesses or services with income that cannot be determined, in accordance with the “Presumptive Tax Law” can be consummated by payment of a flat Patent Fee in lieu of calculating the tax amount using business income as provided for under this Law. This would imply that taxation can be consummated by paying a flat tax without regard to the size of the actual income and this would comply with the taxation principles of ability to pay or fairness. Businesses that would be subject to such treatment would include passenger transportation, cargo transportation, various manufacturing, product selling, medical care and other services or industries that would account for a majority of the industries in Mongolia.

It is perfectly clear that levying of a flat tax without regard for the level of income is not desirable from the point of view of achieving fair and just taxation. Taxation for these industries ought to be properly conducted based upon accurate taxation income derived by deducting from income direct and indirect expenses incurred in order to produce such income. However, at this juncture, due to:

- (a) the low level of taxpayer’s tax awareness, and the impracticality of expecting the filing of income tax returns
- (b) low acceptance of the practice of bookkeeping and the lack of awareness by most taxpayers of accurately calculating income and tax amounts through recording revenues and expenses
- (c) the preponderance of cash-based transactions being conducted and the difficulty for the tax administration in grasping details necessary for taxation
- (d) the inability of the tax administration provide guidance or to perform adequate inspections on the self-employed due in part to the shortage of staff that can be directed to conducting inspections, and
- (e) the tax administration’s desire to realize the minimum amount of tax revenues at the least amount of cost incurred even at the expense of fairness in taxation, the

reality is that the existing system had been adopted as the next best alternative.

In addition, emergence of new businesses that do not fall into the taxation categories under the existing taxation methods, noticeable increases in income levels in some industries exacerbate the imbalance in taxation burden creating major obstacles in taxation.

Elimination of the system in its entirety at this time may be difficult, but sooner or later such a system needs to be reformed and a shift to a tax return system as provided for under this Law should be made. This would result not only in incremental revenues but also enable the assessment of VAT to businesses operated by individuals.

Taxation for businesses and services with indefinite incomes, given its importance, we have attempted to make a detailed study of recommendations for improvements in PART III Chapter 5.

6.3.2 Taxable Income for Livestock Farming

Under the Individual Income Tax Law Article 6, the taxable income is based solely on the headcount of livestock.

However, there can be seen the recent emergence of ranchers selling high priced furs such as cashmere and realizing high incomes. Considering this status, although the basic taxation continues to be based on headcount, a provision should be newly put in place. This new provision shall deal specifically for incomes derived from the sale of high priced furs such as cashmere and mink (including the organism from which furs are taken) separately from the livestock taxable income and be subjected to this Law whereby taxable income is calculated using business revenues and expenses. Note that the items to be subjected to the Law shall be determined by the Director General of the GDNT.

This amendment would not only bring to an end to extremely low tax burden based on livestock headcount, but also it would result in enhancing fiscal revenues and eliminating the unfairness of taxation between those who are able to sell such high priced furs and those who are not.

6.4 Conclusion

We have discussed two major system and execution of taxation issues above and have touched on the necessity to make amends to the current taxation system. However, we must note that there are far too many shortfalls in the prerequisite conditions for a quick resolution to these issues.

In comparison to corporate income tax, for example, the individual income tax is set at low level and it is not common practice to maintain bookkeeping. In addition, there is a low awareness of individual taxpayers about taxes.

On the tax administration side, it would appear that there is an insufficient level of staffing to administer all individual taxpayers including tax inspections. Naturally, tax inspections are conducted primarily on enterprises and its employees or those self-employed persons whose income can be readily identified. Most of the small-scale self-employed persons are assessed a flat tax through Presumptive Taxation.

If this taxation is applied for businesses and services with irregular incomes, it is easy to surmise that most taxpayers would simply fail to file tax returns or file tax returns with artificially low income levels; therefore, in order to alleviate this type of situation, the tax administration will need to utilize more inspection officers and the only way to correct this situation would be the application of Presumptive Taxation (See PART III Chapter 2).

In any case, it will be a futile attempt to restructure the system without the organizational structure in place to support it. Of course, it would be possible to have minor improvements in achieving fair and just taxation by improvisation and improvements in the execution. However, as a more fundamental issue, the tax executive administration must spend the time and persevere in developing educational activities in order to raise taxpayer awareness, enhance the consultative capabilities, augment the tax inspection staffing levels and strengthen the guidance given to the taxpayers.

Chapter 7

7 Items Requiring Amendments that are common between the Corporation Tax Law and the Individual Income Tax Law

7.1 Taxation on Income from Sales of Real Estate

Under both the existing Corporation and Individual Income Tax Laws, gain (transfer price) from the sale of real estate is taxed at a flat 2% (the Corporation Tax Law Article 6 Clause 1, the Individual Income Tax Law Article 8 Clause 3).

The Study Team, for the reasons cited below, has recommended that taxes be determined using the regular tax rate defined under this Law after deducting the acquisition cost and expense directly incurred with the sale of the real estate from sales proceeds. However, in the case of the sale of residence or when the real estate is sold to the country or provinces, the amount of tax credit should be allowed to 10 million Tg at maximum only once in three years for taking consideration of social policy.

- 1) Gain from the sale of real estate is realized at the appreciation of its possessed value at the disposition and is considered to be an unearned income with a high tax bearing capacity.

From the point of view of fairness in taxation, it is not desirable that the tax rates applied to such gain are set substantially lower than those of wage earners, self-employed or incorporated enterprises that raise no such gain. If the rates and taxation method were left as they are, there would be remarkably an increase in the protests raised by those who cannot possess real estate.

Therefore, rather than the application of a 2% special tax rate as it is currently the practice, at the least the basic tax rate applicable under the Individual Income Tax Law or the Corporation Tax Law should be used in the taxation. However, the taxable income should be adjusted by deducting the acquisition costs and expenses directly related to the sale from the sale proceeds to ensure proper tax bearing capacity.

- 2) In Mongolia, it is expected that the privatization of land and buildings will become even more active and along with this sale of real estate is also expected to become

increasingly active.

Further, with the development of the economy, the demand for real estate will increase, which is expected to lead to a rapid escalation in real estate prices.

In such a case the capital gains associated with real estate sales will be substantial and if the burden is very low, this will result in a marked unfairness in taxation. Also if the tax burden on capital gains from real estate sales is low, speculative purchases of land by foreigners will become rampant and form obstacles to a sound real estate policy in Mongolia.

As mentioned above, there is no valid rationale for applying low tax rate to the taxable income relating to the sale of real estate including land and buildings. It should be treated in the same way as the income from the sale of products or rents.

If taxation method for transfer of real estate should be modified as proposed, the way to withhold 5-20% of the transfer price (income) from income and make year-end settlement at tax return should be taken into consideration in order to secure tax revenue beforehand.

<Reference : Estimated incremental fiscal revenue>

The estimated amount of taxation on the gain from real estate for both enterprises and individuals in 1999 (assumption: tax rate 40%) is calculated as follows:

Assume: the tax rate applied were 2% of the gain arising from the real estate, and its acquisition cost were 50% of the sales value.

- (i) 1999 Real estate tax amount 218,015,000 Tg
- (ii) 1999 Gross real estate sales value = (i) ÷ 2% = 10,900,750,000Tg
- (iii) 1999 Profits arising from sale of real estate = (ii) x 50%
= 5,450,375,000 Tg
- (iv) Theoretical 1999 taxation on sale of real estate = (iii) x 40%
= 2,180,150,000 Tg
- (v) 1999 Effective increment in tax revenue = (iv) – (2% of (ii) (2,18,015,000))
= 1,962,135,000 Tg

Chapter 8

8 Items Requiring Amendments in the Value Added Tax Law

8.1 Current State of Value Added Tax (VAT)

Present Day Mongolia is still at a stage where many of the societal and economic prerequisites for the implementation of VAT are lacking. Nevertheless, among the total tax revenues realized in the first half of year 2000, VAT was the largest component totaling 26.6 billion Tg (Mongolian statistics monthly June) accounting for 27% of the central government's tax revenues. If payments for social insurance are to be included, this would represent about 30%.

The importance VAT plays in Mongolian taxation is clear from these figures. Although there are approximately 30,000 registered enterprises, the tax burden is being borne by only 2,054 enterprises (as of April 2000). Individuals were exempted from sales taxes, and at the time of the introduction of VAT, the exemption was allowed to continue and remains true today. Based on such arrangements, the tax authorities maintain a close relationship with these enterprises.

[Note]

Division of Duties by Organization – in the case of Ulaanbaatar

GDNT Inspection Division :

Undertakes on-site inspections, in principle, once every two years (in the case of major enterprises, once every year) by a team made up of two tax inspectors. Conducts routine inspections, including checking for falsification of invoices in all tax cases and confirming tax refund amounts. In the event of a full-scale inspection, performs reconciliation of bookkeeping records. In addition, if necessary, conducts verification checks lasting about a week. This division is one of the most important divisions responsible for tax inspections.

GDNT Tax Assessment Division:

Accepting tax returns and providing guidance in the filing of tax returns are its principal functions. At the time of submission of the tax return, tax administrations require submission of supporting documents such as invoices and interim financial statements. In addition, a summary field inspection that is also meant to provide guidance and which lasts two to three days in duration is conducted in a cycle of once every three years (principally reconciling bookkeeping documents but also conducting verification checks as necessary).

Tax Office:

The corporate form of the enterprises under their jurisdiction is simple and it is judged that understanding the actual situations would not be difficult as the number of enterprises submitting VAT returns is limited.

8.2 Issues and Proposals for Reform

8.2.1 Issues on the Execution of the VAT and Proposals for Reform

Information was gathered from the tax assessment and GDNT Inspection Departments in Ulaanbaatar City. In addition, responsible officials in each department at both the city tax offices and GDNT were consulted regarding the execution of VAT. The items listed below were raised as major issues for the execution of VAT.

- 1) In addition to the enterprise being less than enthusiastic about issuance of invoices, the basic infrastructural requirements in enterprise accounting necessary for the accurate calculation of VAT is undeveloped.
- 2) Scope of exemptions is wide and because there is lack of conceptual clarity, more exemptions are being granted than necessary.
- 3) In addition to setting up the inspection system, measures to enhance the level of qualification of each inspector must be a continuous task.

The issue for the foreseeable future will be how efficiently and accurately the administrative tasks can be performed, including general inspections for confirmation of tax refunds and uncovering of malfeasance and the tools and measures necessary to achieve these.

A major challenge that it faces is widening the VAT tax base. As the ability to maintain the existing type of close relationships with the taxpaying enterprises will wane, creation of a system for conducting inspections must not be overlooked. The management systems for administrating inspections, putting together an information processing system and laying cooperative arrangements with other institutions are all emanating from the same perspective and are items that need to be considered at this stage.

Although significant amounts of the laying out of rules and regulations regarding the tax system and execution have already been completed, evidences can be seen that would suggest that, in the field, the actual execution does not conform to what is provided for in

the statutes. It is essential that there is a good understanding of whether the rules, regulations and instructions issued by GDNT are being carried out in a manner that it was intended to. Its aim is for the supervisory office or supervisory official to create conditions for the responsible officers on the front line so that they can effect the instructions that they had been given and be able to provide support.

8. 2.2 Issues on Individual Cases and Proposals for Reform

(1) Those subject to taxation being more limited than would be necessary

This is caused, in part, by setting the cutoff level for sales to determine tax-exempt eligibility to too high of a level in relation to the overall size of the economy and by the existence of numerous exemption provisions. These require legal redress but there are areas where, in the execution, the taxation scope is left unclear or taxation of the entity deliberately being avoided. It would be desirable to set up execution where subjects of taxation are made clear and the granting of exemptions is limited to only those cases where there is a need.

First, the rationale for exclusion of individuals from taxation is dubious. It is understandable that from the cost benefit standpoint, it would not make sense to perform separate inspections for VAT in a situation where due to being in a business system where income is irregular or due to historical happenstance, it is impossible for the self-employed to prepare the necessary bookkeeping documentation.

However, in the existing situation, performing inspections on marginal enterprises will result in providing the unscrupulous taxpayers an unjustifiable safe haven. From the tax law perspective, exclusion of individuals (who are obligated to pay taxes from the confines of the law) creates issues that cannot be disregarded in attempting to instill a sense of trust in taxation among the people. Measures must be taken as soon as possible to assess VAT to individuals. There may be some limitations under the current conditions but, at the least, groundwork should be laid. For the time being, inspections may be limited to those entities that fulfill certain

preconditions. In any case, methodology for performing inspections on individual taxpayers for VAT should be established.

As mentioned, the plethora of exemptions is also narrowing the field of tax base. Under the current set of reforms, it is hoped that some progress can be seen on this issue. More reductions in the number of exemptions will be necessary, and the national tax authorities, through case examples, must identify information necessary to achieve this purpose. That being said, in order to avoid a “liberal interpretation of the rules”, the “interpretations of the laws and regulations” should be unified. If the perception by the taxpayers that interpretation differ from one tax office to another, or even worse, from one officer to another, is allowed to prevail, the views of the authorities will carry little weight and no improvements can be hoped for in the existing situation where all kinds of interpretations are allowed without any impunity. In order to raise the level of trust of the people toward the tax authorities, the fundamental task of “establishing a clear official stance” need to be undertaken.

(2) Need to enhance the qualification of the tax inspectors

Commenting on the inspectors that we had the opportunity to meet, we found them to be motivated and knowledgeable of sophisticated inspection methods such as case studies and on-site inspections and appear to be carrying out their duties in a professional manner. As for the supervisory officers, although they appeared to be burdened with lack of knowledge, perhaps due to the dearth of practical experience relating to the detailed inspection methods, they too appeared to be motivated and to have strong sense of responsibility.

However, the organization as a whole is another issue. It appears that creation of rules or issuance of instructions is sufficient and there is a lackadaisical approach in ensuring that the rules and instructions are being adhered to in the field. Going to the extreme, if follow-up to ensure the adherence to the rules and instructions that have been given in the field is neglected, then the supervisory offices and management must deal with the situation under the assumption that such rules and instructions are

not being followed. It appears that little consideration is being given to such issues.

In the field operations, for example, tax inspections always require responses that address particular situations as they arise and there are many occasions where the decision-making including the choice of items to be inspected or the focus of the inspections must be made by the inspector on the spot. But at least, for mid-level officers or below, specific instructions should be provided and their performance should be evaluated as necessary. Although some may argue that these are naturally being done, but to the extent that we have been able to observe in the field, the reports of the inspections being filed were simplistic in nature and unobjective and it must be said that as a source of information for the supervisory office to conduct an audit leaves a lot to be desired. The rules call for detailed records to be maintained and it is necessary to prepare guidance reports that give consideration to keeping objective records that can be of practical value as data for ex post facto administration or inspection.

From the point of view of emphasizing the peculiarities of tax field operations, several methods such as day to day instructions provided to junior staff by experienced officers and on-site practical instructions on conducting inspection by experienced officials from the supervisory agency (measures such as jointly conducting inspections while at the same time providing instructions) may be considered. In any case, in addition to measures such as general training or feedback on inspections, practical on-site training in the field on issues that surface in the administration of field inspections is required in order to provide hands-on training that cannot be obtained from the desk job to nurture practical capabilities to conduct inspections. We would recommend that a systemic study of such training methods be made and be introduced.

(3) Establishing the information management system

Various information pertaining to incorporated entities are kept separately in

individual files and there are exchanges of information among the responsible officers when needed. However, the amount of information collected and utilized is quite limited.

To enhance the information collection process, the most basic and the most effective way would be to expand the legally required documentation system. However, there is an urgent need to develop the means to utilize and organizationally foster the sharing of necessary and readily obtainable information through tasks, such as attaching copies of invoices submitted with their returns or obtained in the course of an inspection to the files of the relevant incorporated entity (as the incorporated entities are also attentive with regard to the documents they submit, the effect may be limited). There have been cases where malfeasance had been uncovered by this method and further, in the early stages when the number of incorporated entities are small, by instilling the impression on the incorporated entities that returns will be cross-checked, a restraint may be placed upon invoice issuers, thereby improving the reliability of invoice as documentation. The same can be said for documentation pertaining to procurement.

[Note]

Periodic disclosure of the registration status as a VAT taxpayer is being considered as a means to prevent issuance of invoices by unregistered parties. However, careful consideration must be given to the extent of disclosure of an individual's tax information. If this hurdle can be overcome, then some improvements in the reliability of invoices may be expected.

(4) Implementing presumptive taxation

In the inspection of the VAT, similar to the inspections of expense items in corporate tax inspections, some documentation exist regarding tax refunds which provide a lead for inspectors. However, due to a lack of precedent cases regarding the sales side, it is quite difficult to progress with an inspection. Proper implementation of

Presumptive Taxation is a way of breaking through this situation. However, due to the relative newness of taxation, the tax administration's performance of its function has not inspired confidence among the officials in the judicial sector. As a result, tax administrators may find themselves in situations where their work is not accepted in the courts of law (judicial officials tend to rely on the provisions of civil and criminal laws rather than the tax laws, clearly an unjustified state of affairs). As a result, in the front line of inspection, Presumptive Taxation is perceived as "legally" so to speak, forbidden practice. In reality, taxation based upon estimation is a taxation method that is legally recognized. Rules providing for it have been established. Frontline inspectors have studied the method for implementation and for the inspector, this is, as it was, common knowledge. The fact that due to the mistaken stance taken by judicial authorities that Presumptive Taxation cannot be accepted as common methodology, a major issue is raised not only for VAT but also for the entire tax execution.

GDNT, in order to make the public aware that this method of taxation is a tool that cannot be ignored in the maintenance of fairness in taxation and to establish the methodology as a means of identifying sales figures, needs to take some positive actions (Particularly when a legal action is involved, it would be a situation in which GDNT should respond to. This type of action will provide support to the frontline operations). Although this is equally applicable to other areas (assessing VAT to individuals), a pilot study should be undertaken under GDNT's guidance to establish a unified methodology and concept. We would point this out as an item to be implemented.

The reason for the emphasis being placed on the items that lead to the proper sales is because, in Japan, the deduction of taxes paid up to the prior level of sales is allowed only if the taxpayer has maintained proper bookkeeping records and the assumption is that the same will be true in Mongolia. A careful study is required. However, if this were possible, it would lead to a development of an effective inspection method. In any case, the fact there are many items in VAT inspections that are important and common with that of incorporated entities make tax inspections widely recognized.

Implementation of a single unified tax inspection on an incorporated entity is effective and it should be a matter of course to execute the VAT in conjunction with other forms of taxation. Introducing policies that would contribute to this end is an important issue that needs attention.

(5) Cooperative arrangements with other institutions

The importance of the diversity of information sources and the amount of information in the execution of taxation goes without saying. For example, the existing VAT administration has a close bearing with the assessment of VAT by the customs authorities. In today's Mongolian economy, the principal equipment and materials are being imported and the agency that has the quickest and most extensive coverage is the customs. By obtaining data captured at the customs area and following it up with the enterprises, a fairly precise reading of the enterprise's performance could be obtained. The cooperative arrangement between the two institutions is critical in the smooth running of the VAT administration. From this point of view, GDNT has established a successful track record in establishing a successful close cooperative relationship with the Customs. Similar relationships should also be established with any other institutions that are thought to be useful in gathering information.

In addition to harmonizing with public institutions that possess VAT related information, as a matter of course, it would also be of importance to receive cooperation from private sector institutions. The fundamental infrastructure items such as the extent of the practice of bookkeeping or promotion of taxpayer registrations by the VAT taxpayers continues to be issues that need to be resolved but having a tax accountant promoting such practices with their clients would likely be much more of an efficacious method than GDNT doing so directly. The role of explaining the advantages and the disadvantages from the perspective of an enterprise and promoting the adoption can only be fulfilled by a private sector institution with an understanding of taxes.

Chapter 9

9 Items Requiring Amendments in the Real Estate Tax Law

The Real Estate Tax is a tax imposed on owners of real property and its revenue is relatively easy to estimate compared with other tax items. If the tax rates and the taxable amounts can be set lower, the taxpayers' protest would be limited. Considering these facts and its efficient revenue mechanism, the Study Team has recommended its introduction and it has been enacted and has been put into force.

In the enabling laws, some of the Study Team's views were not incorporated and the recommendations are being presented with respect to the important parts that require amendments.

9.1 Amendment to the Real Estate Tax Law Article 3 Clause 1

The existing Law Article 3 Clause 1 should be amended as follows:

The existing Law:

"The real estate specified under Civil Law Article 77 will be subject to the Real Estate Tax."

Proposed Amendment:

"All real estate, without regard for it being registered or not registered, substantially attributable to the owners shall be subject to the Real Estate Tax. All structures and others constructed by the owners shall also be subject to the tax."

[Commentary]

This article defines the real estate that shall be subject to the Real Estate Tax. The Law should not confined the real estate that has been registered by owners, accordingly the amendment redefines the subject to real estate that is in substance attributable to the owners. It also stipulates that structures and others constructed by the owners shall also be subject to this tax.

9.2 Amendment to the Real Estate Tax Law Article 4 Clause 1

The following should be inserted into the Real Estate Tax Law as Article 4 Clause 1:

“Those who own real estate as of 0:00 A.M. on January 1 of each year in Mongolia as listed below shall be defined as the real estate tax obligor for the property so owned.”

[Commentary]

The Real Estate Tax Law Article 4 defines the scope of the real estate tax obligor. According to this insertion, the regulation specifies tax obligors as those who own real estate as of defined point of time.

9.3 Amendment to the Real Estate Tax Law Article 5 Clause 1

The Real Estate Tax Law Article 5 Clause 1 should be amended as follows:

The existing Law:

“ The real estate shall be assessed by the registered value for taxation purpose. If the real estate is unregistered or uninsured using property insurance value, taxes shall be based on the book value or the property.”

Proposed Amendment:

“The real estate shall be assessed in accordance with a method as stipulated by the tax administration.”

[Commentary]

In the definition of the valuation method contained in the existing law, unregistered real estate is not addressed for taxation. In addition, the values registered at the Mongolian Real Estate Registry Office are the ones that are applied at the time of registration. Since it would be in vain to expect that such values reflect fair value, the method mentioned in the proposed amendment would be one of the criteria used in tax valuation, but cannot be sole criterion for the valuation.

The valuation to determine real estate tax requires appropriate method in light of taxation purpose, thus, it is necessary for the taxation authority, itself, to undertake such valuation.

Accordingly, this amendment stipulates that, each year on January 1st, the evaluation shall be implemented based on valuation methodology determined by the tax authority and the methodology applied to unregistered real estate to fulfill the objectives for the assessment of real estate tax.

9.4 Amendment to the Real Estate Tax Law Article 6 Clause 1

The Real Estate Tax Law Article 8 Clause 1 should be amended as follows:

The existing Law:

“The real estate tax shall be levied based on the valuation of the subject real estate as of January 15th of each year.”

Proposed Amendment:

“The real estate tax shall be levied based on the valuation of the subject real estate as of January 1st of each year.”

[Commentary]

Followed by the amended regulation made to this Law Article 4 Clause 1 that defines those who own real estate as of 0:00 A.M. on January 1st as tax obligors, the above amendment similarly stipulates that the valuation shall be undertaken as of January 1st. If the timing of the tax valuation is to be set as of January 15th as defined before, then the Article 4 Clause 1 can also be amended at the same date.

However, rather than having the taxation event falling mid-month, it would be clearer to set the date as the beginning of the year. In addition, the amendment would also reduce the confusion among the taxpayers.

9.5 Amendment to the Real Estate Tax Law Article 8 Clause 2 and 3

The Real Estate Tax Law Article 8 Clause 2 and 3 should be amended as follows:

The existing Law:

Clause 2 “Incorporated enterprises own real estate shall pay real estate taxes quarterly by the 15th day of the following each quarter month.”

Clause 3 “All Mongolian citizens, aliens and stateless persons shall pay real estate taxes in one installment by February 15th of each year.”

Proposed Amendment:

Clause 2 “Mongolian incorporated enterprises and Mongolian citizens that own real estate shall pay real estate taxes quarterly by the 15th of the following each quarter month.”

Clause 3 “Foreign incorporated enterprises including various agencies and organizations, aliens and stateless persons shall pay real estate taxes in one installment by February 15th of each ear.”

[Commentary]

The amendment of Clause 2, from the point of view that there is no need to classify the treatment between Mongolian incorporated enterprises and Mongolian citizens, stipulate that the same treatment shall be made to both.

On the other hand, the proposed amendment of Clause 3 addresses concerns regarding possible leakage in assessment an payment, thus, stipulates the foreign incorporated enterprises, aliens and stateless persons shall pay the taxes in one installment soon after the tax reporting.

Chapter 10

10 Items Requiring Amendments in the Inheritance Tax and Gift Tax Law

The inheritance tax is a tax imposed on a person acquiring assets as a result of succession. Because the tax bearing potential of the successor is very high, and because the tax contributes toward redistribution of wealth, the inheritance system is highly acceptable by general taxpayers, particularly if the level of basic exemption is set high.

The gift tax is a tax on a person acquiring assets following the receipt of gifts, and the gift tax system has the role of supplementing inheritance tax. Considering that plutocracy is beginning to appear in Mongolia, the Study Team suggests that these taxes be instituted promptly in your country.

Hereunder, we present examples of inheritance tax and gift tax, as well as explanations on their important aspects.

The Inheritance and Gift Tax Law (Proposed)

Article 1 Purpose of This Law

The purpose of this Law is to adjust the imposition of inheritance tax and gift tax on those who obtained assets as a result of inheritance or gift, as well as relations between the tax imposition and budgeted tax payment.

Article 2 Inheritance and Gift Tax Laws/Ordinances

The laws/ordinances regarding inheritance tax and gift tax are composed of the general tax law and the related laws/ordinances.

Article 3 Definitions

3.1 "Inheritance" refers to the action of the party concerned, transferring his/her assets

and ownership thereof to a third party based on the related laws/ordinances or his/her will.

- 3.2 “Gift” refers to the action of the party concerned, putting his/her assets under the possession of a third party free of charge or obligation.

Article 4 Persons Obligated to Pay Inheritance Tax and Gift Tax

- 4.1 The following persons shall be obligated to pay inheritance tax, based on this Law.
- 4.1.1 Persons settled in Mongolia, persons without nationality, and enterprises that obtain assets as legacy.
- 4.1.2 Nonresident Mongolian taxpayers who obtain assets in Mongolia as a result of inheritance or gift.

Article 5 Evaluation of Inherited or Gifted Assets

- 5.1 If assets are obtained through inheritance or gift, asset evaluation shall be carried out based on the market prices of the said assets at that time.

Article 6 Tax Imposition Amounts

- 6.1 If the person who obtained assets as a result of inheritance is a formal consort, the amount derived by deducting 20 million Tg from the inheritance assets shall be the inheritance tax imposition amount.
- 6.2 If the person who obtained assets as a result of inheritance is the actual son, daughter, father or mother, the amount derived by deducting 10 million Tg from the inheritance assets shall be the inheritance tax imposition amount.
- 6.3 Regarding a person who obtains assets as a result of gift, the amount derived by deducting an annual basic exemption of 500,000 Tg shall be the gift tax imposition amount.

[Explanation]

Article 6 defines the imposition amounts of inheritance tax and gift tax. Namely, it

clearly stipulates that, if the heir of inheritance assets is the formal consort, actual son/daughter, etc., the amount derived by deducting a special deduction shall be the inheritance tax imposition amount, and that, concerning a person who obtains gifted assets, the amount after the deduction of an annual basic exemption of 500,000 Tg shall be the gift tax imposition amount.

Considering the degree of contributions to the assets left by the deceased, the basic exemption amount regarding inheritance tax for the consort should be higher than for the other heirs. Concerning gift tax, which is fundamentally a tax supplementing inheritance tax, if special deduction or tax amounts on gift tax are equal to or larger than those of inheritance tax, this will step up tax evasive actions to escape from inheritance tax imposition by reducing large-amount assets through distribution prior to death. Because the possibility of negating the original objective of inheritance tax -- to eliminate the concentration of wealth -- cannot be completely ruled out, the basic exemption amount should be set at a low level.

Article 7 Tax Rates and Tax Amounts

7.1 Inheritance tax shall be the following amounts based on the tax imposition evaluation amounts.

Tax imposition evaluation (Tg)	Tax rates, tax amounts
10,000,001 ~ 20,000,000	10%
20,000,001 ~ 40,000,000	1,000,000 Tg + 20% x revenue above 20,000,000 Tg
40,000,001 ~ 60,000,000	5,000,000 Tg + 30% x revenue above 40,000,000 Tg
60,000,001 ~ 80,000,000	11,000,000 Tg + 40% x revenue above 60,000,000 Tg
80,000,001 or above	19,000,000 Tg + 50% x revenue above 80,000,000 Tg

7.2 Gift tax shall be the following amounts based on the tax imposition evaluation amounts.

Tax imposition evaluation (Tg)	Tax rates, tax amounts
500,001 ~ 5,000,000	10%
5,000,001 ~ 10,000,000	500,000 Tg + 20% x revenue above 5,000,000 Tg
10,000,001 ~ 20,000,000	2,500,000 Tg + 30% x revenue above 10,000,000 Tg
20,000,001 ~ 50,000,000	8,500,000 Tg + 40% x revenue above 20,000,000 Tg
50,000,001 or above	16,500,000 Tg + 50% x revenue above 80,000,000 Tg

[Explanation]

Because the imposition purposes of inheritance tax and gift tax are different, it is natural for the imposition amount of gift tax to be substantially higher than that of inheritance tax. A higher tax imposition amount regarding gift tax is desired, because sales tax imposition is avoided by many taxpayers who say some portions are gifts and not sales, during current tax inspection, since there is no gift tax system at present.

Article 8 Non-Taxable Assets

- 8.1 The following assets shall be exempt from inheritance and gift tax imposition.
- 8.1.1 Assets obtained through inheritance or gift by the government or organizations having state or local public assets.
- 8.1.2 Assets obtained through inheritance or gift by non-governmental organizations engaged in social service.

Article 9 Tax Payment and Tax Declaration

- 9.1 Inheritance tax-related declaration and payment must be implemented “within 90 days” from the starting date of inheritance.
- 9.2 Gift tax-related declaration and payment shall be implemented “within 30 days” from the date of receiving the gift.

[Explanation]

The reason for the difference in declaration and payment periods between inheritance tax and gift tax is that, if voluminous assets exist with regard to inheritance tax, completing the work of grasping and evaluating them during the same period as that for gift tax (30 days) is considered to be difficult; hence “within 90 days” was set.

- 9.3 In the case of a taxpayer who pays tax above 10 million Tg, inheritance tax or gift tax may be paid within 1 year after submitting a tax-related declaration and consulting with the jurisdictional tax administration.

- 9.4 Concerning inherited assets whose conversion into cash is difficult, such as real estate, payment in kind at the imposition price shall be allowed. This shall not apply, however, if the taxpayer does not apply for payment in kind by the legal declaration deadline for inheritance tax or if the said assets are recognized by the tax administration as assets unsuitable for payment in kind.

[Explanation]

When a taxpayer obtains assets with high value through inheritance, it is assumed that assets difficult to be turned into cash for payment purposes are naturally involved. Therefore, this provision is designed to allow payment in kind for such assets. The provision also stipulates that application for payment in kind must be filed by the legal declaration deadline and, if the assets concerned are recognized as unsuitable for payment in kind, such payment will not be allowed.

- 9.4.1 Inheritance tax and gift tax declaration forms shall be set by the Director General of the Government Department of National Taxation.

Article 10 Date of Enforcement

This Law shall be put into effect on _____, 200 .

PART III

**ISSUES IN THE EXECUTION OF TAXATION
AND PROPOSALS FOR REFORM**

Chapter 1

1 Establishment of a Statutory Receipt System

1.1 Objective, Significance and Background

The mission of the tax administration is the implementation of appropriate and fair tax assessment and collection, assuring the complete execution of tax laws and effecting improvements to the tax system. The new tax system has been in place in Mongolia for only a short time and its improvement, the expansion of the taxation base, rationalization and increasing the efficacy of the methods of assessment and collection are issues that confront the system. With the economic conditions in the country in disarray, it is of utmost importance that the above be achieved as soon as possible.

The existence of an underground economy is of particular concern and the tax authority, the revenue administration in the country, has not been able to exact taxation from this sector nor does it possess the expertise needed to do so. This not only creates unfair taxation but also greatly impairs the proper functioning of the Mongolian fiscal system. After considering ways in which taxes can be collected from the underground economy in an efficient and accurate manner, the Study Team proposed the "Statutory Receipt System" as proposed in Phase 1 of the Study. The Mongolian Government gave some consideration for the "Statutory Receipt System", but rather than adopting it has instead decided to adopt "Register System" under the Minister of Finance and Economy or the Director General of the GDNT. However, the register system has the following shortcomings.

- (1) Under the current plan, the implementation of the register system will involve a purchase of a register by each taxpayer, who then will be able to deduct the purchase price from the taxes or from income. The compulsory purchase of the register is somewhat ill advised as even the less expensive registers are priced at over \$700 and it would be difficult to imagine that taxpayers would go out of their way to cook their own goose, so to speak. The thinking behind the use of a tax deduction as an inducement is also fraught with problems since it is the taxpayers who are required to

come up with the money to buy the register and this idea does not fit well with the existing economic realities in Mongolia. In addition, the deduction of the purchase amount from taxes will also mean a corresponding reduction in tax revenues and no guarantee exists that the incremental tax revenues resulting from the introduction of this system would compensate for this revenue reduction.

The register system will be introduced only for large-scale taxpayers, but this will accomplish nothing in dealing with the underground economy. The government has no clear-cut views on how this system would be introduced into the mainstream in the future to cover general taxpayers including small-scale businesses such as the Zaha and self-employed people. If the introduction were limited to only a portion of the taxpaying population, its value, including the effect on incremental fiscal revenues, would be greatly diminished.

- (2) Even after the introduction of the register system, what is to stop a person from transacting business and moving cash about without opening the register? Cash can be stored in places other than the register's drawers. The authorities must recognize that register would then be powerless against those tax evaders whose intent is criminal. The government, however, appears to have taken no notice and harbors the fantasy that the register is a white knight that would save the tax system, which is forcing the Study Team to sound an alarm.

If the system is introduced, it is without a doubt that such a method of tax evasion would be rampant in the underground economy and the register system would have very little effect in the collection of taxes from the underground economy.

- (3) A register would usually not maintain records of the purchaser. Although register records would be useful in the course of conducting inspections of the owner of the register, an attempt to utilize the records to investigate the customer would become an exercise in futility. The actual transaction counterparts would not be identifiable and it would therefore not be possible to efficiently compare the register records with those of the counterpart, thus rendering the register records critically flawed as the sole basis

for confirming the appropriateness of taxpayer returns. Thus this could only function as a supplemental method of inspection to a separate and different method of inspection.

- (4) Under the existing conditions, entrepreneurs have been introducing registers on their own due to necessity in managing their business. Since this trend will probably continue in spite of the many questions that remain regarding the efficacy of the registry system, it would appear that there is no need to rush into the introduction of the system in an environment that is not fully receptive.

As described above, there are many issues that exist in the register system, but in principle the possession of a register by each taxpayer would be very desirable from a tax administration point of view. However, we feel that this would be of very limited value in dealing with the issue of bringing about an efficient and accurate increase in taxes from the underground economy. Given the existing state of the Mongolian economy and the various issues that surround it, the most critical issue is the early creation and implementation of a "Statutory Receipt System," a method that would be effective in offering a simple solution

1.2 Details of the Statutory Receipt System that should be Established

1.2.1 Details of the Statutory Receipt System

The statutory receipt system requires that a statutory receipt be issued for all domestic transactions that involve the payment and receipt of funds and the payment for purchase of goods and services from foreign countries. The issuance of statutory receipts would enable GDNT to accumulate data regarding all transactions in goods and services, and would be an inexpensive yet efficient and the best method for eliminating the underground economy.

The statutory receipt system would require all taxpayers to issue statutory receipts each time there is a receipt of funds related to sales and purchases of merchandise and services with the aim of determining taxpayer's sales and the cost of procurement, appropriateness of its tax returns, and tax calculations based on evidential data including revenues and expenses while also seeking to encourage the establishment of the practice of maintaining of original transactional records.

Introducing the statutory receipt system would increase the efficiency of inspections by tax inspectors, bring about substantial improvement in the possibility of determining tax amounts and result in a substantial reduction in tax evasion including in the underground economy, while ultimately addressing the government's paramount concern, which is the ability of the country to realize fiscal revenues that reflect the true state of economic activities.

The statutory receipt system is comprised for domestic transactions and for foreign transactions. The domestic transaction statutory receipt system is a system based on the issuance of statutory receipts for all transactions within Mongolia and would be a measure that would enable the tax administration to efficiently and easily grasp the entirety of economic transactions being undertaken domestically by the taxpayers. The foreign transaction statutory receipt system would apply regardless of whether the counterpart is a Mongolian or a foreigner when a Mongolian taxpayer (a) procures or receives a service and consideration is paid outside of Mongolia, and (b) receives funds outside of Mongolia for

the sale of goods, whereupon a statutory receipt would be issued. Statutory receipt data would serve as a measure that would enable the tax administration to accurately and efficiently grasp the entire perspective of economic transactions undertaken by Mongolian taxpayers including the purchase from and sales to foreign suppliers and buyers.

An Overview of the proposed statutory receipt system is described below.

(1) Overview of the Statutory Receipt System for Domestic Transactions from the Issuer's Perspective

- 1) Statutory receipts for domestic transactions (domestic receipts) would be provided by the GDNT to taxpayers free of charge and would be used for all valid domestic transactions during the calendar year.
- 2) The domestic receipts would be issued in triplicate with the first copy for submission to the GDNT, the second copy for the transaction counterpart and the third copy for the taxpayer.
- 3) There would be four types of information provided on the domestic receipts: the issuer's taxpayer number, transaction counterpart's taxpayer number, date and the gross amount of the receipt. For transactions greater than 100,000 Tg, details of the product or the specific services recorded would also have to be provided on the receipt.
- 4) The copy for submission to the GDNT would have to be submitted by the taxpayer within a specified time after the close of the calendar year or quarter.
- 5) Domestic receipts would be issued not only to individuals and enterprises but also to national and regional governments with a trigger point above which the issuance of domestic receipts would be required. In principle, any taxpayer who transacts

economic transactions with a value of 5,000 Tg or more must issue a domestic receipt at the time of receipt of funds.

- 6) If domestic receipts were not issued, a penalty equal to a specified percentage of the amount that should have been included on the receipt would be assessed.
- 7) Expenses or assets claimed by taxpayers that are not substantiated by a domestic receipt would not be allowed for tax purposes.
- 8) The issuers of domestic receipts would be required to retain their copies for a period of ten years from the date of issue and violators of this requirement would be obligated to pay a fine equaling a specified percentage of the amount recorded on the domestic receipt.

(2) Overview of the Statutory Receipt System for International Transactions from the Issuer's Perspective

- 1) This is a statutory receipt that would be provided by the GDNT to taxpayers free of charge for use in valid foreign transactions during the calendar year. The statutory receipt for foreign transactions (foreign receipt) would be applicable to all transactions regardless of the location in each of the following cases:
 - (a) when a taxpayer subject to Mongolian tax law procures or receives goods or services from foreign countries and claims payments for such procurements or services as expenses in Mongolian tax reporting and the statutory receipt is issued to evidence the appropriateness of such treatment, and
 - (b) when a taxpayer subject to Mongolian tax laws receives funds outside of Mongolia for sales of products or provision of services and a statutory tax receipt is issued to the counterpart.

- 2) Foreign receipts would be issued in triplicate with the first copy for submission to the GDNT, the second copy for the taxpayer's records and the third copy issued to the counterpart.
- 3) The following information would be provided on each foreign receipt: the issuer's taxpayer number, counterpart details (country, taxpayer name, taxpayer location, contact information such as telephone or facsimile number and counterpart taxpayer number if there is a tax jurisdiction governing the counterpart), transaction date, settlement date, gross receipt amount, date and amount of each installment if receipt is in installments and the details of the transaction would have to be recorded.
- 4) A copy of the receipt for submission would have to be submitted by the taxpayer to the GDNT within a specified period after the close of the calendar year or quarter.
- 5) In principle, no limit would be established for the issuance of foreign receipts.
- 6) Expenses or assets recorded for Mongolian tax reporting purposes without a foreign receipt to substantiate the appropriateness would not be allowed for tax calculations. Furthermore, expenses or assets would likewise not be allowed for tax calculations, if the foreign receipt is lacking and the original receipt issued in the country where the payment or the receipt is made for the said transaction is lacking.
- 7) If a foreign receipt were not issued, a penalty equal to a specified percentage of the amount that should have been included in the foreign receipt would be assessed.
- 8) The issuers of foreign receipts would be required to retain their copies for a period ten years from the date of issue and, if they fail to comply with this requirement, they would be subject to a fine equaling a specified percentage of the amount that should have been included on the receipt.

(3) Overview of the Statutory Receipt System for International Transactions from the Issuer's Perspective

1) GDNT would manage and maintain complete records of all numbered statutory receipts for each calendar year on a computerized database. Statutory receipts would be distributed to each tax administration with strict control over the distribution.

2) When the jurisdictional tax administration distributes the statutory receipts to the taxpayers, it would maintain records of when, where and to whom such distributions were made as well as the recorded numbers of the distributed statutory receipts in a statutory receipt registry. Upon confirmation of documentation establishing the identity of the recipient taxpayer, it would have to store the registry.

The jurisdictional tax administration would promptly report the details of the distributed statutory receipts and the recipient taxpayer to the GDNT. If possible, a system should be created in which this reporting would be executed by directly inputting the information at the jurisdictional tax administration into the central database maintained for each taxpayer and the statutory receipt database at the GDNT.

3) The statutory receipt for submission to the GDNT would in principle be input into the statutory receipt database. This database would accumulate sales and counterpart (procurements) information for each taxpayer.

For example, it would be possible to calculate Taxpayer A's sales based on statutory receipts received from Taxpayer A through cumulative calculation and, furthermore, transactional data for procurements, etc., involving multiple counterparts would each be classified and accumulated in the database by counterpart, which could then be processed by the computer. Thus, if A has 10,000 transactions a year with as many different counterparts, A's annual sales based on the statutory receipts could easily be calculated by a simple computer calculation

and, since counterpart taxpayer numbers would also be recorded on the statutory receipts, the amount and date of transactions with A could be recorded for each of the 10,000 counterparts by computer processing. The annual sales of the 10,000 counterparts that are subject to taxation could be calculated from the statutory receipts submitted by each of the taxpayers and, in addition, since data relating to the procurements of those taxpayers, such as procurements from A, would also be linked at the same time to the relevant taxpayer's database, the use of this statutory receipt system would make it possible, albeit based on the statutory receipt amounts, to automatically calculate income and other data relating to those taxpayers.

- 4) If there were changes to be made to the listing of taxpayers within a reporting period, each jurisdictional tax administration would report such changes to the GDNT and would add or delete the relevant taxpayer to or from the list and distribute statutory receipts or recover outstanding statutory receipts.
- 5) The tax administration would recover and void all statutory receipts that have been damaged or marked by erroneous entry, etc., and remove the relevant records from the registry.

1.2.2 Basis for the Assessment of the Applicability of the Statutory Receipt System in Mongolia

- (1) In general, receipts are issued as a document or evidence that records the facts of an economic transaction where there is an exchange of money between enterprises or individuals, and an issuance of receipts for each transaction should be a social practice that is readily acceptable to enterprises and individuals.
- (2) Currently in Mongolia, VAT Invoices and other forms specified by the GDNT are already in use and large taxpayers have not demonstrated any significant resistance to the use of GDNT forms.
- (3) The taxpayer population including enterprises is small in number and the number of economic transactions is miniscule in comparison with other countries. Thus, it would be relatively easy to introduce the statutory receipt system.
- (4) The fact that an environment for the implementation of taxpayer identification numbers already exists could be pointed out as the most compelling grounds for the practicability of implementing the statutory receipt system.

Enterprises are required to submit to national registration at the time of establishment or registration of activation, at which time they are assigned permanent numbers that serve as the taxpayer number.

In the case of individuals, a registration number (birth date plus a specific number, which is used as a permanent number for each individual) is assigned to each citizen as the taxpayer number.

If these numbers are fully utilized, a statutory receipt system could be introduced that would in effect be based on the taxpayer identification system. The use of taxpayer identification system would make it possible for the GDNT to grasp the details of all economic transactions in the economy, including the underground economy, at the time of exchange of funds in the form of data.

- (5) Potential taxpayers in the underground economy who are currently totally out of the reach of taxation would be reduced significantly as a result of the establishment and implementation of the statutory receipt system. In addition to the acceptance of the system by society as the norm, transaction counterparts would demand the issuance of a statutory receipt in order to assure that the payment of cash would be recognized as an expense or recorded as an asset by the tax authorities and, as a result, potential taxpayers in the underground economy would likely request to be registered as taxpayers and ask to be issued statutory receipts.

1.2.3 Prerequisites for the Establishment of the Statutory Receipt System

(1) Distribution of Statutory Receipts to Taxpayers

Given the benefits accruing to the tax administrations and the acquisition of important original records maintained for each taxpayer, it would be essential for the GDNT to distribute the Statutory Receipts to the taxpayers free of charge. Though there may be budgetary and other issues that arise, there can be no other choice in the matter considering the incremental revenues that would follow.

(2) Inspection of the Issuers of the Statutory Receipts

In order to monitor how the issuers of statutory receipts prepare, issue and store the statutory receipts in the course of the management of their business, the tax administration could conduct inspections as described below. Unannounced spot checks would be appropriate as a way of verifying the appropriateness of the preparation, issuance and retention of the statutory receipts.

- (a) Periodic inspection of statutory receipts
- (b) Unannounced spot checks of statutory receipts
- (c) Comparative checks of values on the statutory receipts against tax returns at the time of their submission

(d) Legal statutory checks conducted together with other tax inspections

(3) Principle of Tax Calculation for the Taxpayer

The various tax calculations would be performed by the taxpayer based, in principle, on the figures recorded on the statutory receipts.

(4) Smooth Establishment of the Statutory Receipt System

For the system to succeed, it is important to effectively incorporate the counterparts who pay funds as consideration for goods and services into the statutory receipt system. As noted above, if the taxpayer required the receipts in order to record expenses and assets for tax calculation purposes for which the receipt and retention of statutory receipts would be mandatory, there is strong likelihood that the system would be accepted at least as far as these taxpayers are concerned; the issue at hand, however, is acceptance by the general consumers. General consumers are normally distanced from taxation and there would be no positive incentive for the consumers to insist upon being given the Statutory Receipts and the success of the implementation of the system would depend upon the ability to transform that mentality. Therefore, in order to assure that a receipt always changes hands at the time of payment of cash, there is a need to devise some sort of scheme that would allow for an incentive for the payers of cash to request or require the receipts.

One method would be to buy the receipts issued by counterparts from cash payers by paying an amount determined either by the aggregate value or the number of receipts presented or, alternatively, holding lotteries using the serial numbers on the statutory receipts that are presented each quarter or periodically with the winners receiving cash or various assets that have been confiscated to compensate for delinquencies or nonpayment of taxes. If the cash payer entered into transactions for the purpose of paying for inventory, thought should be given to setting up incentive schemes such as specified tax reduction programs that would support business activities.

(5) Responsibilities in dealing with Violators

If it becomes clear in a tax inspection that a taxpayer has failed to fulfill the requirement to issue statutory receipts for cash received in exchange for the sale or provision of goods or services, it will be deemed, based on the Process Law, that proper transactional records had not been kept, and taxable income should then be determined based on the calculation of revenues and expenses of taxpayers engaged in similar business activities or some other effectively calculated figures. It would also be advisable to consider the establishment of a system that would enable the tax administration to request the relevant ministry or administration to revoke the authority of any taxpayers who sell or provide services that require special authority but who fail to issue statutory receipts.

(6) Dissemination and Public Promotion of the Statutory Receipt System among Taxpayers

The publication of advisory reports, the distribution of pamphlets and public promotion in the media would be important means for ensuring the smooth implementation of the statutory receipt system.

1.2.4 Measures for the Implementation of the Statutory Receipt System

For the system to succeed, it is necessary first of all to enact laws for the establishment of the system as soon as possible. Time will be required for taxpayers and the general public to become fully aware and accept of the system while GDNT will also have its requirements in terms of time and budgetary measures in preparing the necessary systematization for the statutory receipt system including both software and hardware. The first priority will thus be the creation of a Statutory Receipt Law, which would clarify the time of implementation of the system.

The system would lack the strength that it would require if it were based on a directive of the Director General of the GDNT or the Minister of Finance. It should be a system that has the popular backing of the country and it would be desirable to have it propagated as law.

Next, until systemization is implemented at the GDNT that would enable the computerization of a statutory receipt database, consideration should be given to the establishment of a means for exchanging data between tax administrations that would create an environment that would induce a sense of uneasiness among the taxpayers that their statutory receipts had been taken away by the tax administration, while manually distributing statutory receipt information pertaining to individual taxpayers held by each tax administration to the respective taxpayer files in other tax jurisdictions. The implementation of this means for exchanging data would in effect involve no cost but would make it possible for tax administrations to provide statutory receipts that they had acquired relating to taxpayers in other jurisdictional tax administration, while, at the same time, receiving information relevant to taxpayers in their jurisdictions from other tax administration. If, for example, all tax agencies in Ulaanbaatar were gathered in one place on a certain day to hold a forum for such exchange, it would take less than a day to complete. Exchanges of data could be arranged between taxing agencies in other provinces utilizing mail delivery with GDNT or an Ulaanbaatar Tax Bureau serving as the contact point and should pose no special problems.

1.2.5 Example of the Proposed Statutory Receipt Law

We are pleased to present the following proposal for the Statutory Receipt Law.

Statutory Receipt Law (Proposed)

Article 1: General Provisions

- 1.1. The objective of these regulations is to regulate the preparation and use of receipts issued at the time of the execution of any economic activity including but not limited to the sale or assignment of goods and provision of services.
- 1.2. In order to ensure the accurate computation of taxes due from taxpayers, these regulations stipulate items relating to the preparation, issuance, management and use of receipts that are to be issued at the time of execution of any economic activity including but not limited to the sale and assignment of goods and provision of services.
- 1.3. Receipt shall mean a document that has been assigned a number by the General Department of National Taxation (GDNT) and that records name and the registration number of the seller, assignor and the purchaser, detail description of the sale, assignment or service, category, quantity, unit price, aggregate amount, date and, if a taxpayer of Value Added Tax, items relating to tax computation and the determination of taxable income for Value Added Taxes, etc. (hereinafter referred to as the "Receipt").
- 1.4. Any corporation or individual who engages in the sale or assignment of goods or the provision of services within Mongolia ("Taxpayer") shall, in principle, issue a receipt ("State Authorized Receipt") for any transactions of 5,000 Tg or more and, if a taxpayer of Value Added Tax, all transactions irrespective of the amount. Pursuant to the Income Tax Law for Self-employed Persons Engaged in Businesses and Services with Indefinite Income, Taxpayers whose assessed taxes are based on patents shall also be required to issue State Authorized Receipts.

- 1.5. A list of Taxpayers who will not be required to issue Receipts due to the nature of their business shall be determined by each tax administration with the approval of the GDNT.

Article 2: Issuance of Receipts

- 2.1. Receipts shall be issued by the GDNT under a consistent set of regulations as indicated in the appended information and distributed to each tax administration.
- 2.2. Each tax administration shall distribute the Receipts free of charge to Taxpayers in its jurisdiction who are required to issue Receipts.
- 2.3. Each regional GDNT bureau shall prepare a list each quarter of Taxpayers in its jurisdiction who are required to issue Receipts and shall receive orders for Receipts and provide reports to the GDNT.
- 2.4. If it is necessary to revise the list of Taxpayers who are required to issue Receipts during a reporting period, each tax administration shall notify the GDNT of such revisions and, upon receiving approval, shall remove or add said Taxpayers from the Receipt register and shall recover unused Receipts or issue new Receipts as required.
- 2.5. If, upon application by a Taxpayer, a tax administration deems said taxpayer to be free from its obligation to issue Receipts, each such tax administration shall, upon notifying the GDNT and receiving its approval, remove said taxpayer from the Receipt register and any unused Receipts that may remain shall be recovered. The application submitted by the Taxpayer and other documents relating to deletion from the register shall be retained in semi-permanent storage.

Article 3: Requirements Governing the Receipts

- 3.1. Receipts shall be prepared in accordance with the form stipulated in the appended information.
- 3.2. The Receipts shall bear an exclusive number that identifies the Taxpayer, which shall be preceded by the code of the tax office in question.
- 3.3. Receipts shall not be given duplicate numbers.

- 3.4. Receipts shall be issued in triplicate. First copy shall be for submission to the GDNT, the second copy shall be the actual Receipt to be provided to the transaction counterpart and the third copy is to be retained by the Taxpayer for his records.
- 3.5. Receipts shall be updated each calendar year. They shall consequently be in effect during the year for which they are specified.
- 3.6. Each receipt must contain the following information.
 - (a) The address, location, name, company name, etc., telephone number and registration number of the Taxpayer issuing the Receipt
 - (b) Date of Receipt issuance
If the date of the transaction and the date of issuance of the Receipt differ, the date of the transaction must be noted on said Receipt.
 - (c) The transaction counterpart's Taxpayer registration number
 - (d) Aggregate amount received

Article 4: Obligations of Taxpayers Required to Issue Receipts

- 4.1. Except for specially recognized circumstances, Taxpayers shall issue a Receipt to the transaction counterpart each time money is received for any transactions exceeding 5,000 Tg in value. Taxpayers of Value Added Tax shall issue Receipts for all transactions irrespective of the amounts.
- 4.2. Taxpayers who are obligated to issue Receipts shall register in the register at the jurisdictional tax office and receive Receipts.
- 4.3. When issuing Receipts, Taxpayers must accurately and clearly note details as provided for in Article 3 of the Law.
- 4.4. Taxpayers must retain their copy of Receipts that are issued for a period of ten years from the date of issue.
- 4.5. At the time of tax inspections, Taxpayers shall present to the tax inspector all Receipts issued by the Taxpayer and all Receipts issued by transaction counterparts and received by the Taxpayer during the period subject to tax inspection.

- 4.6. Taxpayers shall submit copies of Receipts to be submitted to the GDNT for each quarter to the jurisdictional tax authority by 15th day of the month immediately following the end of said quarter.
- 4.7. Unused Receipts shall be returned to the respective jurisdictional tax administrations by January 15th of the following year.

Article 5: Use of the Receipts

- 5.1. Taxpayers must issue a Receipt to the transaction counterpart each time money in the amount of 5,000 Tg or more is received for any economic activity including but not limited to the sale or assignment of goods or the provision of services.
- 5.2. When engaging in any economic activity including but not limited to the sale or assignment of goods or provision of services, Taxpayers shall prepare a Receipt in triplicate consisting of a copy to be submitted to the GDNT, an original copy to be provided to the buyer and a copy to be retained by the Taxpayer for his records as provided for in the appended information for each such transaction. All three parts of any receipts that are damaged by the Taxpayer in the preparation process shall be returned to the jurisdictional tax authority and the number of such receipts shall be deleted from the numbers of the Receipts originally granted.

Article 6: Supervision of the Use of the Receipts and Obligations and Rights of the Tax Administration

- 6.1. In order to ensure the suitability of the issuance and content relative to the preparation and usage of Receipts by the Taxpayer when engaging in any economic activity including but not limited to the sale or assignment of goods or the provision of services, each tax administration shall undertake the following:
 - (a) Implementation of periodic inspections
 - (b) Implementation of non-periodic inspections
 - (c) Implementation of confirmation inspections of unused Receipts

- (d) Implementation of various activities including lotteries based on the numbers imprinted on the receipts in the possession of consumers, Receipt buy-back, etc.

Article 7: Obligations of the Receipt Recipient

- 7.1. Each time a Taxpayer pays money to a counterpart in exchange for any economic activity including but not limited to the sale or assignment of goods or the provision of services in the amount of 5,000 Tg or more shall have a Receipt issued by said counterpart and retain such receipt in storage for a period of ten years.
- 7.2. Taxpayers must make sure that Receipts received from the counterpart contain include the following information:
 - (a) The address, location, name, company name, etc., telephone number and registration number of the Taxpayer issuing the Receipt.
 - (b) Date of Receipt issuance
If the date of the transaction and the date of issuance of the Receipt differ, the date of the transaction must be noted on said Receipt.
 - (c) Taxpayer's taxpayer registration number (passport number in the case of individuals).
 - (d) Aggregate amount received

Article 8: Responsibilities

The following obligations shall be imposed upon Taxpayers, individuals or corporations that violate these regulations and related laws.

- 8.1 If it is revealed during the tax inspection that a Taxpayer engaged in an economic activity including but not limited to the sale or assignment of goods or the provision of services in the amount of 5,000 Tg or more and received monetary compensation for such activity but did not issue a Receipt to the counterpart, an amount of taxable income shall be estimated based on the profit and loss of peers and other detailed

computations and, if it is revealed that the Taxpayer's non-issuance of a Receipt was without just cause, a penalty shall be levied in the range of 5% - 50% of the amount that should have been recorded for the transaction, etc., had a Receipt been issued. The amount of the penalty shall be determined by the director of the jurisdictional tax administration.

- 8.2 If a Taxpayer who has taxable income and the obligation to pay taxes fails to retain original copies of the Receipts issued or received evidencing the taxation under said tax laws for the required period of ten years, a penalty shall be levied in the range of 5% - 50% of the amount that should have been recorded on the said Receipts. The amount of the penalty shall be determined by the director of the jurisdictional tax administration.
- 8.3 If a Taxpayer receives benefits deriving from any economic activity including the acquisition of goods valued at 5,000 Tg or more or received services and paid monetary amounts in consideration for such activity but failed to receive a Receipt from said counterpart relative to said payment, expenses relative to Receipts that have not been received shall not be allowed as deductible expenses in the Taxpayer's calculation of taxable income.
- 8.4 If a Taxpayer with special approval who engages in economic activity including but not limited to the sale or assignment of goods or the provision of service in an amount of 5,000 Tg or more received monetary compensation from the counterpart in consideration thereof but did not issue a Receipt to said counterpart, the jurisdictional tax administration may request the competent authorities to rescind said Taxpayer's business license.

Article 9: Enforcement

The regulations shall become effective as of [date].

Chapter 2

2 Presumptive Taxation

2.1 Purposes for Preparing Guidelines for Presumptive Taxation

This chapter serves as the “Guidelines for Presumptive Taxation”.

As stated below, a self-assessment tax system is adopted for individual income tax, corporate income tax and VAT in Mongolia. Therefore, taxpayers who operate enterprises must personally calculate taxable income and tax amounts based on bookkeeping documents that record operational revenues and expense, in principle.

In reality, however, it is extremely difficult to ask all taxpayers to calculate tax amounts based on actual figures recorded in accounting books.

Meanwhile, because it is a great principle of taxation for all taxpayers to bear taxes in an appropriate and fair manner, based on provisions of laws and ordinances, no taxpayer will be allowed to escape from tax payment for reasons of inability to implement accurate income calculations due to the lack of accounting book records. This is based on the viewpoint of establishing a fair balance with taxpayers who carry out appropriate tax returns based on accounting books.

Presumptive taxation means estimating income based on some indirect data, other than accounting documents, when bookkeeping records do not exist and, therefore, accurate income calculation is impossible. Accordingly, it is the right and obligation of tax administration that have the mission of implementing appropriate and fair taxes to carry out presumptive taxation.

In the inspection of non-declarers or excessively small declares by the tax inspectors in charge, the practice of calculating income and expenditure based on talking to the taxpayers, examination of trade partners and data/information from the organizations concerned, and determining operational profits are actually implemented when accounting books related to operational transactions or original data/records are not available. However, we cannot disregard the current situation in which, when presumptive taxation is disputed at a court trial,

tax imposition is canceled at a fairly high rate. Although many factors are conceivable for this state of affairs, particularly in the case of presumptive taxation, the biggest reason is considered to be insufficient verification of “need for presumption” or “reasonableness of presumption” based on objective evidence data.

“Guidelines for Presumptive Taxation” in this chapter are designed to provide a theoretical and systematic guide, regarding specific presumption methods in the case of presumptive taxation, to handle such situations. In addition, they would be useful in determining taxable incomes which are needed for calculating taxes such as individual income tax, corporate income tax or VAT.

Although this guide is an easy-to-understand summary of the basic thinking in the case of estimating income, it should be first recognized that the methods stated herein cannot be used for all lines of business at any time and as they are.

Accordingly, in actual presumptive taxation, it is important for tax inspectors themselves to think deeply and devise the most reasonable and objective presumption methods, while referring to the methods and reasoning shown in the guidelines.

Further in the future, we would like to request that this guide be suitably added to, deleted from, or otherwise revised to become better to meet the prevailing situation in Mongolia, based on actual examples of presumptive taxation.

2.2 Self-Assessment Taxation System and Presumptive Taxation

2.2.1 Provisions Relating to Self-Assessment Taxation System

Article 9 of the General Tax Law 《Provisions for Tax Payment》 Clause 1 states that “tax shall be imposed based on income tax returns submitted by incorporated enterprises or income tax returns filed by individuals or through withholding at source”, and Article 10 of the same law 《Taxpayer’s Obligations》 Clause 2 provides that “calculations and returns regarding taxation and tax payment shall be submitted to the tax office by the due date.”, while Clause 3 of the same Article stipulates that “journals and ledgers shall be recorded in accordance with the rules and accounting reports shall be submitted”. Article 8 of the Law on Supervision of Tax Assessment and Payment and Tax Collection 《Records and Retention of Evidential Documents regarding Taxes and Accounting Documents》 provides that “the taxpayer shall prepare evidential documents that clarify items that are subject to taxation and the assessment amount in accordance with the laws.”, and again Article 15 《Calculation of Tax Amounts and Inspections》 Clause 1 stipulates that “taxpayers shall calculate its own tax amounts based on related documents and books and shall record such amount in the tax report....”

Therefore, under the Law it is intended that, in principle, taxable income and tax amounts for both the corporate and individual income tax are calculated by the taxpayer based on accounting records including journals and ledgers and other accounting documents. Accordingly, by submitting an income tax return that contains the results of such calculations and makes tax payments. In another words, for both the corporate tax and the individual income tax purposes, self-assessment system has been adopted for both corporate and individual income tax.

2.2.2 Provisions for Presumptive Taxation

The General Tax Law Article 24 《Authority of the Tax Administration and Tax Inspectors》 Clause 1(ii) stipulates that “taxes will be levied based on a model as determined by the Law in the case of taxpayers who do not maintain journals or ledgers and cannot define revenues and expenses”. Article 15 of the Laws on Supervision of Tax Assessment and Payment and Tax Collection 《Calculation of Tax Amounts and Inspections》 Clause 1 provides that “if it is deemed that the taxpayer erroneously calculated tax amounts, the tax amounts shall be determined by an inspection by the tax administration and tax inspectors”. Along with this provision, Clause 2 of the same Article provides that “the tax administration and tax inspectors will determine tax amounts by calculations based on information and recorded documents, by inspection or by approximating the amount in comparison with other taxpayers, if the taxpayer fails to file a return by due date or does not record tax amounts in the filed return.” Furthermore, Article 17 of the same Law 《Calculation of Tax Amounts in Comparison with Others》 Clause 1 provides that “in cases where a taxpayer is engaged in production or service, or it is uncertain that the taxpayer is engaged in such activities, but does not maintain evidential documents relating to the business or maintain books or records that they keep are incomplete and has not submitted the documents and tax reports necessary to file taxes, the tax administration shall perform calculation in comparison with others”. Clause 2 of the same Article stipulates that “calculation of tax amounts in comparison with others means that if a taxpayer exists in the same region who are engaged in substantially the same production or service of substantially the same scale and conditions, such case shall be adopted, but if no such taxpayer exists, the tax amounts shall be determined based on the scale, revenues and expenses and other data of several taxpayers in the vicinity. If the taxpayer was engaged in the business for two consecutive years prior to this taxation year, tax amounts may be calculated based on the documents and books relating to those periods”.

On the other hand, the latter portion of the Individual Income Tax Law Article 5 《Calculation of Taxable Income》 Clause 2 《Taxable Income of Self-employed Taxpayer》 provides that “the taxable income is undetermined or indeterminable, the tax administration shall determine tax amounts based on comparisons with other self-employed taxpayers in similar natural, climatic and market conditions and with similar products.”

That is to say, in the case of incorporated and individual self-employed, if no books are kept or

are incomplete if kept, or other evidential documents such as invoices, receipts, contracts, certificates, or memos (referred to collectively as "original records") necessary for the calculation of income are lacking, and thus rendering it impossible to calculate said taxpayer's income from business revenues and expense figures, it provides, in effect, for the determination of income based on comparisons with taxpayers who are engaged in the same production or provision of service of the same scale and under the same conditions in the same area.

The above provisions provide the tax administration with authority to recognize income that has been calculated based on the indirect methodology of comparisons when the calculation of income is not possible due to the lack of bookkeeping or other original records. From the perspective of fairness under taxation, it would not be tolerable to forgo the imposition of taxation simply because of lack of necessary bookkeeping or original records, and this can be interpreted as providing for, in an instructional manner, the justly held authority of the tax administration in income certification.

Below, we refer to the calculation of income based directly on bookkeeping figures (actual amounts) relating to business revenues and expenses as actual amount taxation and, in contrast, income calculated indirectly such as through comparisons shall be referred to as Presumptive Taxation.

2.3 Provision of Directives relating to Presumptive Taxation

A directive (the Director General of the GDNT Instruction No. 98 Dated September 3 1996 Attachment 2 “Rules Regarding Presumptive Taxation”) was issued by the Director General of the GDNT, in response to the provisions regarding presumptive taxation in the General Tax Law, Laws on Supervision of Tax Assessment and Payment and Tax Collection and the provisions regarding the Individual Income Tax Law as described in 2.2 above. Under the rules, it provides that presumptive taxation methods may be applied if those engaged in manufacturing and provision of services do not maintain accounting documents relating to the business activities or if the books are not being kept in accordance with the Laws, and lists the following three alternatives as methods for presumptive taxation.

- (1) If there is a taxpayer who is engaged in manufacturing and the provision of services with the equivalent production capacity and in the same condition in the same area as the subject taxpayer, then presumptive taxation will be applied based on the revenues, profits, expenses and other items of account settlements of the manufacturing and service business of such taxpayer.
- (2) If said taxpayer has been engaged in similar business for at least two consecutive years prior to the current taxation year, presumptive taxation shall be applied based on documents and accounting books relating to those operations.
- (3) Presumptive taxation shall be applied based on operating records.

2.4 Matters for Special Attention in the Application of Presumptive Taxation

The significance of presumptive taxation, its basis and methods of estimation are described in sections 2.2 and 2.3 above; however, the following items must be borne in mind when applying presumptive taxation.

The method of presumptive taxation must correspond reasonably to the taxpayer to whom it is applied and, rather than a method that is predetermined by the business in which the taxpayer is engaged, the method of estimation should differ depending on such factors as:

- (a) the types of business in which the said taxpayer is engaged,
- (b) the facts had been uncovered in the course of the inspection, and
- (c) the types of operating books or original records have been identified in the course of the inspection of the taxpayer.

Thus, it is essential to adopt the most appropriate estimation method based on the said facts and data. The facts and data that are uncovered are varied and individually unique, and many different methods of estimation using such data are possible. Thus, the inspector must use originality and ingenuity, while adopting the generalized estimation methodology described below, when deciding upon the manner in which to calculate figures that are as objective as possible.

Presumptive taxation does not mean a special taxation treatment, but it is merely basing the calculation of income on indirect data such as comparisons (presumptive taxation) as opposed to calculating the income based on direct data such as accounting books relating to operating revenues and expenses (actual amount taxation). Thus, the difference between the two taxation methods is merely the difference in the way in which the income is recognized. Since presumptive taxation is applied when actual amount taxation cannot be implemented even with ordinary tax inspections that are thoroughgoing, there is an obvious need to improve the level of expertise in general inspections.

2.5 Method of Estimating Income

As stated above, the method of estimating income must be the most reasonably appropriate method selected from among many that are possible based on the taxpayer's business, facts identified during the course of the inspection, and data relating to the business. Below we have attempted to outline methods that could be generally considered.

When displaying the method of estimation of income, the method of computation of the business profit (Editor's Note: in Japan this is generally referred to as "Business Profit") must be made clear as a precondition, and the terminology used in the estimation needs to be made consistent. Thus, after a discussion of the formula and definition of terminology and classifying the estimation methods, detailed discussions on specific estimation methods will be made.

2.5.1 Formula for the Calculation of Gross Income and Business Profit

① Sales - ② Cost of Goods Sold = ③ Gross Income ("gross profit" in Japan)
(Revenue) (Cost of Procurement)

③ Gross Income - ④ General Expenses = ⑤ Business Profit ("income" in Japan)

[N.B.] General expenses are expenses (e.g., personnel expenses, rents and cost of consumables) that are authorized by Law as expenses, in addition to the Cost of Goods Sold (hereinafter "CGS").

2.5.2 Definition of Terminology

- 1) "Cost of Goods Ratio" is the proportion of the CGS in the Sales.
<Formula> Cost of Goods Sold Ratio = (ii)CGS ÷ (i)Sales
- 2) "Gross Income Ratio" means the proportion of Gross Income to Sales.

- <Formula> Gross Income Ratio = (iii)Gross Income \div (i)Sales
- 3) “General Expense Ratio” means the proportion of General Expenses to Sales
- <Formula> General Expense Ratio = (iv)General Expenses \div (i)Sales
- 4) “Expense Ratio” means the proportion of the sum of CGS and General Expenses to the Sales.
- <Formula> Expense Ratio = ((ii)CGS + (iv)General Expenses) \div (i)Sales
- 5) “Business Profit Ratio” means the proportion of Business Profits to Sales.
- <Formula> Business Profit Ratio = (v)Business Profit \div (i)Sales

2.5.3 Classification of Estimation Methods

(1) Estimation Method using the Ratio Method is a method for estimation

Business profits or the basis of its calculation, sales, CGS and others by the application of specified ratios to the amounts of revenues and expenses, production, sales of the taxpayer. The followings are four major types:

1) Peer Standards (editor’s note: “Peer Ratio” in Japan)

The peer standards is a method of estimating business profit by selecting a number of companies in the same business (as many as possible would be preferable but a minimum of 2 to 3 if the number of similar business is limited) that share similarities in terms of characteristics such as the format and scale of the business and location (“similar peer”). The next step is calculating the average CGS Ratio, gross income ratio, expense ratio, business profit ratio and sales per employee of the similar peers (these are referred to as the “peer standards”, and the ratios referred to respectively as “CGS Standard”, “gross income standard”, “expense standard”, “business profit standard”, “per employee sales standard”, etc.) and applying such standards.

[N.B.]

This methodology is used when either sales (including sales estimated using efficiency method described below), CGS or general expenses of the taxpayer is known (in such case sales, CGS, or general expenses that used as the base data for

the estimation is referred to as the “basis for the estimation”). Furthermore, it has objectivity and the resulting estimate is considered to approximate actual income, which shall facilitate acceptance by the taxpayer. This is Method 2.3 (1) outlined in the Director General directive “Rules Relating to Presumptive Taxation”.

If a self-employed taxpayer wishes to use incorporated enterprises as similar peers in estimating income, the differences between individual and corporate income in calculation methods must be considered and the following formula, which converts corporate income to an individual income base, must be applied:

Equivalent Individual Income = pretax corporate income + (compensation paid to directors and, of employee wages, amounts paid to the representative and his family included in operating expenses) + (of interest paid and rents paid included in the expenses, amounts paid to representative and his family) – (of the amounts included in profit amounts income received from the representative and his family such as rent income, interest on loans, etc.)

【 Formula for the Estimation Method using Peer Standards 】

(a) If sales of the inspected entity is used as the basis of the inspection:

$$\text{sales} \times \text{similar peer's business profit standard} = \text{business profit}$$

(b) If CGS of the inspected entity is used as the basis for the estimation:

$$\text{CGS} \div \text{similar peer's CGS standard} = \text{sales}$$

$$\text{sales} \times \text{similar peer's business profit standard} = \text{business profit}$$

(c) If general expenses of the inspected entity is used as the basis of the estimation:

$$\text{general expenses} \div \text{similar peer's general expense standard} = \text{sales}$$

$$\text{sales} \times \text{similar peer's business profit standard} = \text{business profit}$$

[N.B.]

See 2.5.4 (2) for an example of calculation using business peer standard.

2) Own Ratios

The estimation methodology using own ratios estimates the business profits, etc. by calculating and applying the average CGS ratio, gross income ratio, expense ratio, business profit ratio, sales per employee from:

- (a) business performance or record for a specified period of time,
- (b) partial records and data,
- (c) records or inspection results, etc, from the previous year or past years and,
- (d) ratio of omissions from the records (results are referred to as “own ratios”).

[N.B.]

This is applied when the taxpayer’s bookkeeping records or transaction documents for the tax year in question or for past years is incomplete but usable. However, records of past years can be only used if there have been no material changes in business conditions or format since the time of the past records. Own ratios have a higher level of similarity than similar peers and it is a reasonable method.

This is the method outlined in 2.3 (2) of the Director General directive “Rules Relating to Presumptive Taxation”.

【Formula for the Estimation Method using Own Ratios】

- (a) If the estimation is based on the prior year’s business results (base quantity (numerical value) for water usage fees, power usage fees):

$$\text{(prior year's revenues} \div \text{prior year's base quantity (numerical value))} \times \text{(basic quantity (numerical value) of the year in question)} = \text{year's revenues}$$

Example:

$$\text{prior year's income 10,000,000 Tg.} \div \text{prior year's water usage 400 liters} \times \text{year's water usage 500 liters} = \text{year's revenue of 12,500 Tg}$$

- (b) If bookkeeping records for a specified period are used:

a. $\text{(sales during a specified period of the inspected entity)} \times \text{(ratio of Sales of a similar peer during the same specified period to annual sales)} = \text{sales for the}$

year for the inspected entity.

Example:

(sales of 4,000,000 Tg representing the inspected entity's sales from January through April) \times 12,000/3,000 (ratio of similar peer's sales from January through April which was 3,000 compared to its annual sales 12,000 Tg) = 16,000,000 Tg inspected entity's sales for the year

- b. (sales during a specified period of the inspected entity) \times (ratio of annual procurements (consumption) to the procurement (consumption) of the inspected entity's principal product (expense) during a specific period) = sales for the year of the inspected entity

[N.B.]

This formula is used when the sales for the inspected entity can be determined only for a specific period but annual procurement of principal products can be determined.

Example:

5,000,000 Tg inspected entity's sales from January through April
 \times 3000/1000 (ratio of examined entity's annual procurement of its principal product of 3,000,000 Tg to 1,000,000 Tg representing procurement of the principal product for this period)
 = 15,000,000 Tg the inspected entity's sales for the year

3) Inspection Ratio

This is an estimation method that uses inspection ratios to estimate business profit based on the results of field surveys of all business peers located within the jurisdiction of the tax office by calculating the average business profit standards and applying the business profit standard.

[N.B.]

This method attempts to estimate income by using the average values of multiple taxpayers while the ratio method attempts to approximate actual income as

precisely as possible. The tax office would need to compile data relating to the average value of the peers that are targeted in the inspections.

Example:

In the tax jurisdiction of S tax office, the ratio of business profits to sales for all restaurant operators examined in 1999 averaged (business profit standard) 40%. If the year's sales for R, the inspected entity, were 30,000,000 Tg., the year's business profits would be $30,000,000 \text{ Tg.} \times 40\% = 12,000,000 \text{ Tg.}$

4) Average Ratio

This is an estimation method that uses average ratio to estimate business profit (business profit standard) using a ratio that has been derived by taking average business profit ratios, that have been purged of abnormal values, based on inspection results from a significant number of cases to which actual amount taxation has been applied (not limited to the inspection results from the jurisdictional area of the tax office but from all tax offices in the country)(this ratio is referred to as "average ratio").

[N.B.]

The average ratio method is based on the same basic approach as the inspection ratio method. While the inspection ratio method limits the subject area of the business profit standard to the jurisdictional area, the average ratio method takes entire country as the subject area. Therefore, the inspection ratio takes the regional peculiarities into account, enabling it thereby to provide a figure that more closely approximates the actual income than estimation using the average ratio. The average ratio is prepared at GGNP level based on tax inspection results of all classifications of business; however, as a non-disclosed data, it would be appropriate to use it as an indicative level of business profit standards when conducting income inspections.

(2) Per-Unit Method (Per Unit Value Method)

With the estimation method using the per-unit method, indices of business activity or

business scale data, for example sales (revenues) per unit of sales volume, raw material unit volumes, number of employees, equipment, power and water are calculated when the taxpayer's sales, procurement account, etc., are unknown. Based on this data, the sales (revenues), CGS, business profits etc are estimated. In this case, it is used in tandem with the ratio method.

[N.B.] For specific examples see 2.5.4 (1) below.

(3) Asset and Liability Fluctuation Method (Net Asset Comparison Method)

Instead of utilizing the profit and loss calculation method of revenues and expenses, the estimation method using asset and liability fluctuation uses net fluctuations in net assets, or the balance sheet method [(end of period assets – beginning of period assets) – (end of period liabilities – beginning of period liabilities) + consumption (living expenses etc.) – non-operating income = business profit] to directly estimate the business profit. It can be considered a reasonable methodology since the resultant business profit coincides with the business profit derived from profit and loss calculation based on the principle of double entry bookkeeping.

[N.B.]

This method of estimation assumes that the amount calculated by deducting income derived from non-business sources from the sum total of the increase in net assets and household expenses, such as living expenses, is income derived from business without the need to know anything at all about operating revenues and expenses. The difficulty with this methodology is whether or not it is possible to precisely ascertain all assets and liabilities at both the beginning and at the end of the term.

For specific examples, see 2.5.4 (3) below.

(4) Consumption Method

This method, which should probably be considered a variation of the asset and liability fluctuation method, and estimates income from the taxpayer's living expenses and other consumption expenditures.

[N.B.]

This method is based on the assumption that, if there is no change in the asset or liability and there is no inflow from sources other than business, there must be at least sufficient business income to apportion amounts to living expenses and other consumption expenditures.

2.5.4 Estimation Method by Case Studies

(1) Estimation of Sales (Revenues) by the Per-Unit Method

If there are no accounting books or original business records, it will be necessary to determine sales, procurement and general expenses by means of interviews with the taxpayer and employees, confirmation of the product volume and prices on the premises and checking with clients or suppliers; in many cases, however, it is difficult to accurately ascertain values for all items. This is especially true when all sales, procurement and general expense items are transacted in cash. In such cases, one effective method would be to calculate business activity indices and business scale data, or formal factors ("efficient factors"), such as per unit revenues of the taxpayers or a similar peer ("efficiency coefficients") and estimate revenues or business profit based on efficiency coefficients.

In using this methodology, the efficiency factor must fulfill the following conditions:

- (a) there must be a correlation exists with the value to be estimated and they must have a proportional relationship,
- (b) it must be a major component in ascertaining the taxpayer's revenues,
- (c) it must be accurately ascertained, and
- (d) it must be possible to collect the same item from similar peers.

Thus, it is important to select the efficient factors that most closely conform to the business and business format and, at the time of the inspection, the business conditions and equipment capacity of the taxpayer must be ascertained accurately and concretely.

1) Types of Estimation Methodologies using Per-Unit Method

The following are some types of estimation methodologies using the per-unit method:

- (a) Estimation using the usage volume of raw materials
- (b) Estimation from the volume of usage of consumables
- (c) Estimation from the volume of consumption of electricity, water and fuels such as gasoline
- (d) Estimation based on size indicators such as number of employees and equipment
- (e) Estimation based on operating days and etc.

2) Efficient Factors and Efficiency Coefficients

The Table 2-1 outlines the efficient factors and efficiency coefficients thought to be reasonable for principal types of business.

3) Formulae for Per-Unit Method

A. Estimating revenue using machinery, equipment and etc.

a. Per chair : e.g. bars, saloons, barber shops, beauty parlors, etc.

(similar peer's average revenue per chair) \times (inspected entity's number of chairs) = revenue

Example:

Similar peer for a barbershop has an average revenue per chair of 500,000 Tg
 \times inspected entity operates 2 chairs = revenues of 1,000,000 Tg

b. Per machine: e.g., printing, etc.

(similar peer's revenue per machine) \times (inspected entity's number of machines owned) = revenue

Example:

The similar peer of a printer has an average revenue per machine of 1,000,000 Tg
 \times inspected entity owns 2 machines = revenues of 2,000,000 Tg

Table 2-1 Efficient Factors and Efficiency Coefficients

Business Classification	Efficient Items	Indication of Efficiency Coefficient
Merchandise retailers	Number of employees	Revenue per employee
	Retail floor space	Revenue per 1 square meter of retail floor space
	Number of operating days	Revenue per operating day
	Inventory	Revenue per 10,000 Tg. of inventory
Eating and drinking establishments (continued)	Number of employees	Revenue per employee
	Amount of liquor procured	Revenue per 10,000 Tg. of liquor procured
	Number of tables and chairs	Revenue per chair (table)
Eating and drinking establishments	Number of guest rooms	Revenue per guest room
	Consumption of electricity and water	Revenue per 1 unit of electricity and water consumed
Wholesalers	Number of employees	Revenue per employee
	Number of operating days	Revenue per operating day
	Inventory	Revenue per 10,000 Tg of inventory
	Packing and freight charges	Revenue per 10,000 Tg of packing and freight charges
Manufacturers	Number of employees	Revenue per employee
	Consumption of electricity and water	Revenue per 1 unit of electricity and water consumed
	Machinery and equipment	Revenue per 1 machinery and equipment
	Materials expenses	Revenue per 10,000 Tg of materials consumed
	Contracting expenses	Revenue per 10,000 Tg of contract expenses
Transportation	Number of employees	Revenue per employee
	Number of vehicles	Revenue per vehicle
Coffee shops and tea salons	Consumption of coffee beans	Revenue per kg. of coffee beans consumed
Automotive Service and Repair	Number of vehicles tested	Revenue per vehicle inspected
Beauty parlors and barber shops	Materials used	Revenue per 10,000 Tg of materials consumed
	Consumption of electricity	Revenue per 1 unit of electricity
	Number of chairs	Revenue per chair

c. Revenue per employee: e.g., bars, saloons, barbershops, beauty parlors, etc.

- (similar peer's revenue) \div (similar peer's number of employees) = similar peer's average revenue per employee
- (similar peer's average revenue per employee) \times (inspected entity's number of employees) = revenue

Example:

- Saloon's similar peer's revenue 2,100,000 Tg \div similar peer's number of employees 3 = similar peer's average revenue per employee 700,000 Tg
- Similar peer's average revenue per employee of 700,000 Tg \times inspected entity's number of employees 2 = revenue 1,400,000 Tg

B. Estimating Revenue from Procurement (Consumed volume)

The consumed volume of the principal materials is first ascertained.

a. Eating and drinking establishment, sellers of goods, manufacturers

$$(\text{inspected entity's procurement of principal materials}) \div (1 - \text{similar peer's ratio of procurement of principal materials to revenue}) = \text{revenue}$$

Example:

Inspected entity's procurement of principal materials 30,000,000 Tg \div (1 – similar peer's ratio of procurement of principal materials to revenue 40%) = revenue 50,000,000 Tg

b. Bread Bakeries

$$(\text{number of bags of flour purchased in a year}) \times (\text{number of loaves per bag of flour}) = \text{annual production volume of bread}$$

$$(\text{annual production volume of bread}) \times (\text{average price per loaf of bread}) = \text{revenue}$$

Example:

Number of bags of flour purchased in a year 30 \times average of 100 loaves of bread per bag of flour = annual production of bread 3000 loaves

Annual production volume of bread 3,000 loaves \times average price of 100 Tg per loaf = annual revenue 300,000 Tg

c. Bar Operators

(Number of bottles of beer purchased in a year) \times (similar peer's average revenue per bottle of beer) = annual revenue

Example:

Inspected entity's annual purchase of beers of 3,000 bottles \times similar peer's revenues per bottle of beer 5,000 Tg = annual revenue 15,000,000 Tg

C. Estimating Revenue from General Expenses (Consumed Volume)

a. Estimating revenues from consumption of electricity: e.g., cleaners

(similar peer's annual revenue) \div similar peer's electricity consumption)
 \times (inspected entity's electricity consumption) = annual revenue

Example:

Similar peer's annual revenue of 25,000,000 Tg \div similar peer's annual electricity consumption 1,000 KWH \times inspected entity's electricity consumption of electricity 900 KWH = annual revenue 22,500,000 Tg

b. Water Usage ; e.g., public bath-houses, saunas

(Similar peer's average bath usage revenue per unit of water consumption) \times (inspected entity's water consumption) = annual bath usage revenue

Example:

Similar peer's average bath usage revenue per 1 kiloliter of water consumed 300 Tg \times inspected entity's consumption of water 30,000 liters = revenues from bath usage 9,000,000 Tg

c. Gasoline Consumption :e.g., transportation

(Inspected entity's annual expenditures for gasoline) \times (similar peer's transportation revenue per 1 kiloliter of gasoline \div similar peer's expenditures per 1 kiloliter of gasoline)
 = annual transportation revenue

Example:

Inspected entity's annual gasoline expenditure of 1,000,000 Tg \times similar

peer's transportation revenue per kiloliter gasoline expenditure 30,000 Tg ÷
 similar peer's average per kiloliter gasoline expenditure 15,000 Tg = annual
 transportation revenue 2,000,000 Tg

- (Similar peer's average revenue per unit of gasoline consumed) ×
 (inspected entity's volume of gasoline consumption)
 = revenue

Example:

Similar peer's average revenue per 1 kiloliter of gasoline consumed 30,000 Tg
 × inspected entity's volume of gasoline consumption 70,000 kiloliters =
 revenue 2,100,000 Tg

d. Number of Polyethylene Bags Used :e.g., cleaners

- Total X polyethylene bags purchased × revenues per X bag + total Y
 polyethylene bags purchased × revenue per Y polyethylene bag + total Z
 polyethylene bags purchased × revenue per Z polyethylene bag =
 revenue

[N.B.]

The classification of X, Y and Z polyethylene bags indicates differences in
 size and quality of the polyethylene bags used for different types of apparel
 each with a different cleaning charge.

e. Number of Packaging Cellophane Bags Used :e.g., socks finishing

- Number of cellophane bags used × finishing revenue per pair of socks =
 revenue

D. Estimation from Number of Operating Days

a. Fortune tellers

Monthly fortune telling clients (actual figure) × average fortune telling charge
 per customer (actual figure) × 12 months (operating months) = annual revenue

b. Shoe repairs

Repair revenue per day (actual figure) × annual operating days = annual

revenue

c. Bars

Revenue per day (actual figure) \times annual operating days = annual revenue

d. Grocery stores

Sales during a specified period (actual figure) \div operating hours during the specified period \times operating hours per day \times annual operating days = annual sales

[N.B.]

When making estimations using operating days, estimate of per day or per month headcount and monetary amounts will be considered reasonable if they represent a general average value throughout the year; however, this method is prone to produce a variance in the estimate results, and, therefore, should be used only when other appropriate estimation methods cannot be applied.

(2) Estimation Business Profit by Peer Standard

In estimating the business profit using peer standard, if either sales (revenue), CGS (cost of procurement) or general expenses or if a major cost component of CGS or major component of general expenses can be ascertained, the business profit is estimated by applying CGS standard, general expense standard, business profit standard, etc., using the ascertained value as the basis of the estimation. The basic thinking behind the estimation and the method of calculation is explained below, using the example of a bar operation and hypothetical values.

[Case Study]

The inspected entity "X" operates a bar in a busy section of the city.

It was found upon visiting the bar that no bookkeeping records relating to business revenues and expenses were recorded or retained. With no other alternatives, interviews with the owner and onsite confirmation were conducted during night-time operations and it was confirmed that there were three employees in addition to the owner who tended to the customers.

In following up with the owner, it was found that beer, wine, vodka and other liquor was purchased in cash from Store "Y" nearby and, upon checking with Y, Y had fortunately kept a record of sales made to X and confirmed that liquor procurements totaled 2,100,000 Tg. The procurement of snacks and hor d'oeuvres was unclear since the owner stated that he purchased them from vendors that came to the bar directly and he was not aware of their names or addresses; therefore, the precise figures were not ascertainable.

In order to estimate the business profit from comparison with similar peers, the inspector selected three entities A, B, and C in the tax office jurisdiction that were generally similar to in business scale, employee number and location. Of the similar peers, the figures used for A were first adjusted as the result of an inspection to the reported amount and the reported amounts for B and C were also rather small but not thought to be out of the ordinary; thus, were adopted for the estimation.

The breakdown of business profits and the CGS Ratio are shown in the Table 2-2.

Table 2-2 Calculation Table of Business Profit

(Unit: 1,000 Tg)

Classification		Similar peer		
		A	B	C
①	Sales	18,000	16,000	10,000
② Cost of Goods Sold	③ Procurement of liquor	2,700	2,300	1,800
	Proportion of liquor to sales (③ ÷ ①)	0.15	0.14	0.18
	④ Procurement of snacks and hors d'oeuvres	600	400	300
	⑤ Total (③ + ④)	3,300	2,700	2,100
	CGS ratio (⑤ ÷ ①)	0.18 5,500	0.17 4,600	0.21 3,500
⑥	Gross income (① - ⑤)	14,700	13,300	7,900
	Gross income ratio (⑥ ÷ ①)	0.82	0.83	0.79
⑦ General Expenses	⑧ Personnel expenses	5,500	4,600	3,500
	Proportion of personnel expenses to sales (⑧ ÷ ①)	0.31	0.29	0.35
	⑨ Other expenses	900	700	500
	⑩ Total (⑧ + ⑨)	6,400	5,300	4,000
	General expense ratio (⑩ ÷ ①)	0.36	0.33	0.40
⑪	business profit (⑥ - ⑩)	8,300	8,000	3,900
	Ratio of business profit to sales (⑪ ÷ ①)	0.46	0.50	0.39
Notes	Number of employees	4	3	3

- Liquor procurement standard (average proportion of liquor procurement in the sales of similar peers) = $\{(A) 0.15 + (B) 0.14 + (C) 0.18\} \div 3 = 0.16$
 - Personnel expense standard (average proportion of personnel expenses to sales of similar peers) = $\{(A) 0.31 + (B) 0.29 + (C) 0.35\} \div 3 = 0.32$
 - Business profit standard (average ratio of business profit to sales of similar peers) = $\{(A) 0.46 + (B) 0.50 + (C) 0.39\} \div 3 = 0.45$
- Estimation using the proportion of liquor procurement to sales
 - (Liquor procurement of inspected entity X) 2,100,000 Tg \div (similar peer's liquor procurement standard) 0.16 = (X's sales) 13,125,000 Tg
 - (X's sales) 13,125,000 Tg. \times (similar peer's business profit standard) 0.45
= (X's business profit) 5,906,000 Tg
 - If the liquor procurement cannot be ascertained but only the personnel expenses of 4,300,000 Tg can be ascertained.
 - (Inspected entity X's personnel expenses) 4,300,000 Tg \div (similar peer's personnel expense standard) 0.32 = (X's Sales) 13,437,000 Tg
 - (X's sales) 13,437,000 Tg \times (similar peer's business profit standard) 0.45 = (X's business profit) 6,046,000 Tg

[N.B.]

Estimation using liquor procurement and personnel expenses as the basis for the estimation is allowable when a correlation is deemed to exist with sales.

(3) Estimating Business Profit Using Asset and Liability Fluctuation Methods

As it has been pointed out, asset and liability fluctuation method is not based on revenues and expenses but is a balance sheet method that uses fluctuations in the value of net assets [(end of period assets – beginning of the period assets) – (end of period liabilities – beginning of period liabilities) + consumption expenditures (living expenses etc.) – revenues from sources other than business = business profit]. Thus, in order to make

estimations using this method, the accurate value of asset and liability items must be ascertained. The procedure for estimation using this method is explained below.

1) Ascertaining Net Assets

The balances of asset and liability items at the beginning and end of the period are accurately ascertained for the year subject to the inspection. In this case, care must be taken to assure that, if there has been an increase in an asset item, there is also an offsetting decrease in cash/deposits or an increase in a liability item. If there has been an increase in a liability item, it is necessary to check to see if there is an increase in an asset item acquired by the proceeds

A. Common Items

- (a) Accurately ascertaining the values of assets and liabilities items through taxpayer's financial statements, tax returns and interviews.
- (b) The beginning and end of the period can be treated as the same value in the case of items that are deemed to have been unchanged between the years such as Cash, Inventory, Merchandise, etc.

B. Deposits

Deposit amounts should be ascertained through inspections with financial institutions. In this case, deposits in the name of family members are also added as the basis for the calculation of income, but though it is necessary to confirm that family members do not have other sources of income such as wages since, if such exists, it would not be added to business profit and should be deducted. If there is a reduction in the balance of deposits, it is confirmed whether or not an asset was acquired with the proceeds.

C. Accounts Receivable, Accrued Receipts etc.

Accounts Receivable values should be ascertained by checking with customers

D. Building and Auxiliary Equipment

Acquisition Costs including construction costs and acquisition expenses are

ascertained. Adjustments for depreciation should be made through the liability account accumulated depreciation

E. Vehicular Transport Equipment, Tools and Accessories

Acquisition prices are ascertained by acquisition expenses. Adjustments for depreciation should be made through the liability account accumulated depreciation.

F. Account Payables, Accrued payments etc.

Accounts payable should be ascertained accurately by checking with suppliers.

G. Borrowings

Borrowings should be confirmed with financial institutions. It is necessary in this case to confirm whether the borrowing is for business or personal use. If there has been an increase in borrowings, it is necessary to check to see whether other assets have been purchased using the proceeds.

H. Accumulated Depreciation

Accumulated depreciation is calculated by adding the year's depreciation expenses to the outstanding balance as of the period end in the prior year.

I. Changes in Net Assets

Changes in net assets are calculated by deducting the balance at the beginning of the period from that at the end of the period for each asset and liability item and subtracting the aggregate changes in net liabilities from the aggregate value of the changes in assets.

2) Ascertaining Consumption Expenditures (Living Expenses etc.) to be Incremented

It would be reasonable to assume that consumption expenditures (living expenses etc.) are made out of the revenues from the business. It would thus be necessary to add such amounts to net assets, when calculating business profits. The following are some examples of what would be considered consumption expenditures.

A. Living Expense

In regard to living expenses, if data such as standard household living expenses surveyed by region and by family size is available, it should be used; however, if no such data exists, aggregate groceries, clothing, furniture purchases, normal educational expenses, rents, ceremonial occasions, travel and other expenses would be ascertained through interviews with the taxpayer or his family, and annual living expenses would be estimated.

B. Incremental Amounts Other Than Living Expenses

Money expenditures for purposes other than living expenses and not classified as business expenses would include the following:

- Taxes such as income tax, regional taxes
- Repayment of household borrowings
- Large one-time expenditures such as university entrance fees, marriage expenses, overseas travel etc.

C. Ascertaining the Amount to be reduced as Non Business Revenues

Revenues from sources other than business are not included in the business profit calculations, and must be thus deducted from net assets. Non-business revenues may include the following.

- Deposit interest
- Dividend income from stocks

Table 2-3 Calculation of Business Profit Using Asset and Liability Fluctuation Methods

(Unit: 1,000 Tg)

Item			① Beginning of period value (January 1)	② End of period value (December 31)	③ Change (②-①)
Assets	Cash	a	200	200	0
	Deposits	b	6,300	7,100	800
	Accounts receivable	c	1,000	1,000	0
	Inventory	d	3,000	3,000	0
	Buildings	e	6,000	6,000	0
	Equipment and motor vehicles	f	1,200	1,200	0
	Total	g	17,700	18,500	800
Liabilities	Accounts payable	h	420	650	230
	Borrowings	i	5,100	4,700	△ 400
	Accumulated depreciation	j	2,518	2,761	243
	Total	k	8,038	8,111	73

Value of net assets (g-k)		l	9,662	10,389	727
Addition	Living expenses	m			4,412
	Income tax	n			89
	Regional taxes	o			118
		p			
		q			
	Total	r			4,619
Deduction	Deposit interest	s			121
	Dividend income	t			0
	Total	u			121
Business profit (l+r-u)		v			5,225

Table 2-4 Presumptive Calculation of Depreciation

(Unit: 1,000 Tg)

Classification	Acquisition cost	Useful life	Depreciation expenses		
	Base value of depreciation	Ratio of depreciation using straight line method	Accumulated amount as of end of prior year (①)	Current period depreciation expense (②)	Accumulated depreciation expense (①+②)
Buildings	6,000	40years	2,160	135	2,295
	5,400	0.025			
Automobiles	1,200	10years	358	108	466
	1,080	0.100			
Total			2,518	243	2,761

[N.B.]

1. Since there are asset, liability and other items in addition to the above, they should be added as required.
2. If irregularities appear in annual business profits as a result of making estimations by the asset and liability fluctuation method but no changes have taken place in business conditions during the year, it may be due to the omission of some values, which will require a reexamination.

This method should be avoided if there are difficulties in ascertaining values, in which case it will be necessary to select another more appropriate estimation method to estimate business profit.

