

## **Chapter 3**



### **3 Corporate Income Tax Inspections**

The Mongolian system for tax imposition on enterprises is built on a self-assessment system, similar to those adopted in various other countries. Under this system, the enterprises themselves, which are the taxpayers, calculate taxable income and tax amounts, and report them to the tax authorities. The tax authorities, on their part, supplement taxpayers' actions to indicate figures that are accurate and appropriate under tax law and ordinances, by enforcing "tax inspections."

Accordingly, without this "tax inspections," fairness and equality in bearing the tax burden cannot be ensured, and the protection of the property rights of the people cannot be attained. Without it, therefore, it would be impossible to satisfy public demands; in other words, it would be unfeasible to meet the fiscal demands of the nation.

Tax inspections consequently play an important role in realizing appropriate taxation under the self-assessment system.

#### **3.1 Issues in Corporate Income Tax Inspections**

In the corporate taxation system in Mongolia, there is a problem of inefficiency in the inspection system in ascertaining the appropriateness of taxpayers' declarations of income and taxes. Specifically, inadequacy is seen in the selection of inspection targets, methods of preliminary inspections, tax inspection methods, and the tax evidence data system.

In this chapter, therefore, we will propose steps to improve these systems, methods, and arrangements.

## **3.2 Proposals for Reform on the Corporate Income Tax Inspection System**

### **3.2.1 Reform on the Selection of Inspection Targets**

#### **(1) Reform on the Rough Screening of Inspection Target Enterprises**

In the rough screening of actual inspection target enterprises, it is important to select, on a priority basis,

- (a) enterprises for which information or inspection data of unfair transactions (“Information Data” to be described later) have been obtained,
- (b) enterprises with remarkable expansion of operational scale,
- (c) enterprises conducting transactions with inspection target enterprises,
- (d) enterprises involved in priority inspection business (to be explained in (4) below),  
and
- (e) enterprises to be contacted cyclically (to be explained in (2)2) below) and  
enterprises to be contacted continuously (to be explained in (2)3) below).

Next, management conditions should be examined based on submitted data, such as financial statements, and a “tax record” (to be explained in 3.2.4 below), and abnormal figures and unfair portions should be extracted and studied through tax analyses (management analysis), including ratio analysis, for the eventual purpose of choosing target enterprises for on-site inspection.

Therefore, past income declaration and tax inspection matters of enterprises should be entered in the tax record. Based on that information, enterprises should be divided into three classes (“Taxpayer classification by compliance level”), and taxpayers (enterprises) should be managed by classifying them in terms of sales amounts (“Taxpayer classification by sales amount”). In order to raise inspection efficiency, a priority inspection formula should be adopted, based on an effective combination of the “Taxpayer classification by compliance level,” resulting from the qualitative management classification to be proposed hereunder, and the “Taxpayer classification by sales amount,” resulting from the sales amount classification. In this case, booming business

lines should be selected based on analysis of the economic situation (“Taxpayer specification by priority inspection businesses”). Target selection should be carried out based on an overall judgment of these arrangements.

A “data information system” (to be explained in 3.2.6 below) should furthermore be established in order to enhance the effectiveness of these processes as a means for selection.

**(2) Introduction of a “Taxpayer classification by compliance level” in target selection**

All enterprises are categorized into compliance level based on past tax returns, payments and inspection results: A Enterprises (inspection not required), B Enterprises (enterprises to be contacted cyclically for 3-5 years), and C Enterprises (enterprises to be contacted continuously). A method of inspecting malicious high-class enterprises, beginning at the stage of preliminary review, should also be adopted.

**1) A Enterprises (inspection not required)**

Enterprises not requiring inspection are those classified as follows: (a) enterprises with clear and appropriate past accounting and tax reporting records, (b) enterprises with no record of taxation rejections, (c) enterprises with no record of tax delinquency, (d) enterprises and their representatives with a good reputation and cooperative in tax payment, (e) small-scale enterprises with a low level of sales, and (f) enterprises in the process of business suspension, dissolution or liquidation.

Tax inspections of these enterprises should not in principle be conducted for a period of five years after the judgment. They will be rated again after the lapse of five years.

**2) B Enterprises (enterprises to be contacted cyclically)**

Enterprises to be contacted cyclically are those that meet the following standards: (a) Enterprises that are subject to simple error correction or rectification execution each

time, (b) enterprises whose declaration amounts are close to the industrial standard, yet some doubt remains, and (c) enterprises that require cyclical contact although there is no bad reputation or doubt about them or their representatives.

Inspections of these enterprises should in principle be conducted every three or five years. Actual inspection will be implemented, however, if questionable or abnormal values or portions are found during the preliminary inspections, or if information or data indicating dishonest acts are obtained.

### 3) C Enterprises (enterprises to be contacted continuously)

Enterprises to be contacted continuously are those that satisfy the following standards: (a) enterprises with tax returns always subject to correction, (b) enterprises that always have the possibility of fraudulent acts in tax calculations and filing, (c) enterprises or their representatives that have a bad reputation, and (d) enterprises about which information or data is constantly found regarding fraudulent acts.

These enterprises should in principle be carefully managed on a continual basis by conducting precise tax inspections every year, even if there seem to be no particular problems.

### **(3) Introduction of a "Taxpayer classification by sales amount" in target selection**

Enterprises should be divided into five classes based on sales amounts and grouped into three categories based on these classes; those in the classes 1-2 should be classified as low-class enterprises, those in the classes 3-4 as middle-class enterprises, and those in the class 5 referred to as high-class enterprises. The high-class enterprises should be selected as priority inspection targets, while inspection of low-class enterprises should in principle be omitted. Middle-class enterprises meanwhile should be made the targets of cyclical inspection. Inspection should be implemented even in the case of middle- or low-class enterprises, however, if omissions or malignant tax evasion are either suspected or confirmed. The purpose of the suggested arrangement is to effectively utilize the limited number of tax inspectors.

**(4) Designation of “Priority inspection businesses” in target selection**

The designation of priority inspection business is another means for effective utilization of the limited number of tax inspectors. Since it would be impossible to contact all taxpayers under the present situation, inspection should be carried out with emphasis placed on large-amount and malicious taxpayers, as well as taxpayers in business lines that require inspection, apart from declaration and inspection results in the past.

The designation targets of priority businesses should in principle be industries that are flourishing at that time. The designation should be executed by the GDNT, if these businesses exist throughout the country. In response to the designation by the GDNT, local tax bureaus and tax offices should add other business lines in accordance with the characteristics of their respective areas, and carry out inspection of enterprises in designated/added businesses on a priority basis.

### **3.2.2 Improvement of the Preliminary Inspection**

Preparations should be made for the prior inspection of enterprises roughly screened as inspection targets, referred to as “preliminary inspections”. It is important at this stage to determine the points of inspections, based on a study of data (data file system described below) and special characteristics of the businesses and conditions concerned.

#### **(1) Study based on tax records**

Tax records are the past taxation records of the taxpayer concerned. They contain the accounting figures for the taxpayer over the past several years in order to allow a yearly comparison of business and tax payment records. They also include the primary content of past tax inspection.

Written tax files and tax records of on-site inspection targets should be collected and maintained under the control of tax inspection sector managers, who would check, examine and sort out abnormal figures or dishonest portions and examine the importance of the cases. At the conclusion of the preliminary inspection, the managers would divide written declarations into cases requiring on-site inspection and cases of inspection omission. The reason for this arrangement is that it is impossible and unnecessary to examine all enterprises.

Plans for the task of on-site inspections should be prepared once the preliminary inspection targets are divided into those cases to be examined and those not to be examined and entry into the tax record is completed.

#### **(2) Study based on data files**

In order to assure proper filing levels, it is essential to collect data about taxpayer-transactions and assets, in addition to appropriate and accurate tax inspections. This matter will be addressed in 3.2.6 below.

It is necessary to collect effective data and information on all occasions through the documentation of transactions of certain enterprise with other businesses that may, for



example, avoid accurate filing. It is also necessary to gather data, based on the content of advertising and publicity documents of individual enterprises, using newspapers, magazines, TV, radio and other media.

### **3.2.3 Final Selection of Inspection Target Enterprises**

Preliminary inspections should be conducted only of the documentation in the case of written tax returns roughly screened based on the Taxpayer classification by compliance level, the Taxpayer classification by sales amount and the Priority inspection businesses formula. These written tax returns, preliminary inspection documents and tax records should be collected and retained by senior inspectors of the inspection sector, whereupon the need for on-site inspections would be determined based on the standards below and inspection-target enterprises finalized.

The following items can be given as selection standards used on that occasion,

#### **< Items of Selection Standards (initial selection) >**

- ① Cases in which dishonest transaction information was obtained
- ② Cases in which dishonest transactions are judged to have been implemented based on information obtained in the course of on-site inspections of other enterprises
- ③ Cases in which tax returns are failed
- ④ Cases in which financial statements are deemed to contain padded figures
- ⑤ Cases in which the operational scale expanded sharply, as seen in the new establishment and expansion of plants, stores, etc.
- ⑥ Cases in which extremely abnormal figures are found for the term under review but for reasons that are unclear.

#### **< Items of Selection Standards (second selection) >**

- ① Cases in which the income is considered to be too small, and expenses are believed to be too large, compared with other companies
- ② Cases in which gross profits on sales have declined enormously compared with

other companies or past records

- ③ Cases in which sales and profits are unchanged, not reflecting an alteration of business conditions
- ④ Cases in which the enterprise was changed to a cyclical inspection target after a period of time (3-5 years) with no inspection conducted
- ⑤ Cases of bad tax histories due to the discovery of malicious dishonesty or disguised concealment in the previous inspection
- ⑥ Cases of enterprises in their first term after corporate establishment
- ⑦ Cases of enterprises in priority inspection business lines

The initial selection is for the purpose of choosing on-site inspection targets with a high-degree of priority that are certain to be selected, and the second selection is for the purpose of choosing targets to be checked after inspection of the initial targets.

#### **3.2.4 Improvement of the Tax Records**

A tax record is the tax payment record of the taxpayer and is the tax register of the taxpayer, so to speak. It should be improved to achieve simplification and standardization, so as to serve as a reference when selecting tax inspection target and conducting on-site tax inspections.

- (1) Items rejected in the course of the tax inspections, filed items, the content of tax returns and other information are recorded in the tax record, and data about the enterprises in question is filed in the tax record, thereby concentrating information about the enterprises in the tax record.
- (2) The tax record is utilized not only in the rough screening and preliminary inspection stage but also is of pivotal importance in the course of on-site inspections and subsequent to their completion. First, in the rough screening stage, it should be used primarily in the selection of inspection target enterprises and, in the preliminary inspection stage, it should be employed as basic data for the determination of

inspection items. In the future, furthermore, it should be used as material for a computer database.

- (3) The improvement of entry items for the tax record should be implemented as explained below. A thick sheet of paper is folded in two, with entries and columns imprinted on the four surfaces on the front and reverse sides. The form should be designed to record determinations made during the course of inspections from beginning to end and allow for the detailed entry of inspection results.

1) 1<sup>st</sup> page

The content of the principal products handled, conditions of the employees, facilities, company representatives and his family members -- namely, information necessary to ascertain the overall conditions of the enterprise -- should be entered on this page. In other words, this page should be used to help grasp the overall conditions of the enterprise at a glance.

2) 2<sup>nd</sup> and 3<sup>rd</sup> pages

Figures for items on the profit and loss statement and balance sheet should be arranged to permit comparison with several years in the past. These pages should also allow sequential year comparison of gross profit on sales and other managerial analysis ratios, with questionable matters recorded in detail. In other words, these pages should be arranged to allow a comprehension of financial conditions and operational performance, based on a comparison of the recorded figures and analysis ratios, as well as the discovery and extraction of questionable and abnormal matters.

3) 4<sup>th</sup> page

Records of declaration guidance, content and results of inspections, and precautions for the following and subsequent terms, should be entered in detail. In other words, this page should be designed to indicate the content of inspections and judgments on resultant achievements.

### 3.2.5 Improvement of Inspection Methods

Whether or not disparities will arise between the enterprise's tax payment amount based on its tax return and the tax amount set as a result of the tax inspection, under the self-assessment system poses a major problem. There are several causes of disparities and the most typical cause can probably be considered the difference between the taxpayer and tax inspector in the recognition of facts and the interpretation and application of law.

The self-assessment system is a system under which enterprises calculate the amount of tax to be paid and then, declare and pay the amount. Although this system itself can be given a certain degree of positive evaluation, it is difficult, on the other hand, for all taxpayers to accurately understand the tax system and pay the proper amount of taxes, because of the complexity and difficulty of understanding the tax laws. Accordingly, there is no guarantee that all persons will correctly understand the tax system and make the proper tax payment. In many cases, furthermore, taxpayers do not implement tax return and payment in compliance with tax laws. If this situation is left uncorrected, it will unavoidably impair the fairness of taxation. A notable sense of inequity is beginning to arise in Mongolia due to the many cases where tax returns are failed or taxes are not paid.

The basic principle of the tax inspection is checking to make sure that the calculations of the taxpayer are correct. This is where the necessity of tax inspections lie.

Next, it is essential to implement tax inspections efficiently and effectively and, tax evidence data is necessary for this purpose. In the present tax administration of Mongolia, however, no tax account system has yet been adequately established, nor has a system of tax evidence data. As a result, the tax inspection method is quite inefficient. Highly efficient tax inspections would be possible if the tax evidence data system were introduced throughout the entire economy and society of the country. The system would also be beneficial to taxpayers because tax evidence data would serve as material to support their contentions, rendering inspections by the tax authorities unnecessary.

**(1) Diversification of tax inspection methods**

It is desirable to check, through tax inspections, if tax returns of all enterprises are correct in view of tax laws. In reality, however, it is impossible to conduct total checks, because of a shortage of inspection staff and time.

It is necessary thus to diversify tax inspections in accordance with their applications and purposes. It would, therefore, be desirable to divide tax inspections into compulsory, special, general and simple inspections, and to utilize these in line with the applications and purposes of the inspection.

**1) Compulsory inspections**

Compulsory inspections would be carried out to determine if taxpayers who are suspected of violating the tax law have actually committed taxation crime. This is what is referred to as an "investigation" and, though implemented according to the same method as the general inspection described below, it would include the possibility of raids and searches, checking and the seizure of property, based on the permission of a judge. Compulsory inspections would be designed not only to examine the appropriateness of tax returns by taxpayers but also to bring accusations against inspection targets, leading to indictment by a prosecutor.

In implementing compulsory inspections, tax inspectors conduct secret investigation in advance and they undertake simultaneously investigations not only of the head office, branches, plants and the residence of the president of the enterprise, but also business partners, the main bank and other financial organizations doing business with the enterprise. The officials would usually present a search and seizure warrant and would execute the inspection in a fairly coercive manner.

**2) General inspections**

This is a general form of inspection to be executed by reading through accounting books and other materials, asking questions and examining documented evidence,

with the taxpayer's cooperation as a premise. Though general inspections would be carried out by checking and confirming actual items and accounting books, it may not be possible to grasp the actual condition of the taxpayer.

3) Special inspections

General inspections have the shortcoming of being unable to conduct investigations that would be as thoroughgoing as compulsory inspections. Special inspections would be designed as an intermediate form of inspection between compulsory and general inspections.

4) Simplified inspections

This is a method of inspection often referred to as a "one-point inspection," with the aim of investigating a specific item of the taxpayer. As such, it would require fewer days to conduct than other types of inspections.

**(2) Excellent achievement study meetings**

Each national tax bureau should hold "excellent achievement" study meetings to examine new cases that were uncovered or examples of violations common in business circles among the individual tax inspection cases of the year and to share related knowledge among tax inspectors. The bureau should also establish a system to commend successful inspectors, improve incentives for excellent inspection achievements and encourage inspection skill enhancement on the occasion of these meetings.

Cases to be taken up at the excellent achievement study meetings should be those characterized by good perceptiveness and unique inspection methods, resulting in the identification of serious tax evasion. In order to provide reference materials to realize improvements in the work of other officials, the bureau should avoid concentrating the cases to be taken up in specific business lines or enterprises of a specific scale but instead should select suitable cases from as broad a perspective as possible.

The Director General of the GDNT or the director of the tax bureau should commend inspectors at the meeting in order to make it the highest honor for inspectors to have

cases that they handled introduced or to be given the opportunity to announce such cases during the study meeting.

### **(3) Improving the consulting and guidance system**

Besides tax inspections, consulting and guidance for taxpayers should also be implemented in parallel with the tax inspections. Since there are many taxpayers with little knowledge regarding tax affairs, it is important to guide these taxpayers in making appropriate files before trying to find their violations through tax inspections. To attain this, it is necessary to establish a system under which free tax consulting would be offered at no charge to help taxpayers who encounter problems in the course of tax returns.

It is also necessary to introduce correct methods of filing as well as erroneous interpretations of tax laws seen frequently in the past to newly established businesses and enterprises faced by problems shared by others in the same business and to guide them correctly so that they do not commit errors in the future.

#### **3.2.6 Establishment of a Tax Information System and Its Effective Utilization**

If a suitable level of tax returns is to be secured, it is essential to collect data regarding transactions, assets, etc., of the taxpayers in addition to appropriate and accurate tax inspections.

It is not necessary to store data regarding taxpayers if taxes are imposed on all taxpayers under a tax assessment system. Under the current self-assessment system in which the inspection of all taxpayers is not possible, however, the role played by data is considered great. Data and information should be a major cornerstone of tax inspections, together with on-site inspections, to support a high level of tax returns.

In view of the extensiveness of the scope covered by data and information and the great volume available, it can be useful as means not only to raise the overall level of tax returns but also to effectively select inspection targets. Intensive study should therefore be given

to the nature of the data and information system to be established.

**(1) Improvement of the personnel structure conducive to the collection of data and information**

The collection and utilization of data and information are essential for the effective execution of tax inspections. Efforts should therefore be made to form and establish a system to collect and utilize data and information.

Specifically, data officers should be posted in tax bureaus and tax offices and a system for the development, collection and analysis of information necessary for tax inspections should thereby be founded. Furthermore, extensive and orderly systems for the development, collection, analysis and exchange of information and data should be established based on mutual collaboration nationwide scale.

**(2) Method of utilizing data and information**

Since the data and information that is collected has strong potential as external evidence, it should be used at the stage of rough screening and preliminary inspections. Specifically, it should be utilized as evidence to substantiate facts about transactions and records and employed as a powerful means for the selection of on-site inspection targets.

In tax inspection, dishonest practices, such as sales record omissions and the entry of fictitious purchases, should be identified by collating and cross-checking the collected data and financial statements. The data and information that is collected serves as a direct and certain investigative tool that is vastly superior to inspections based on managerial analysis and the like and the collection and utilization of data and information should therefore be prompted.



**(3) Contents of data and information to be collected and collection methods**

Non-statutory materials are numerous, including information about the establishment of companies, data files regarding sales, purchasing, rebates and the like and data files developed during tax inspections of other enterprises. It is important for tax officials to catch facts for tax imposition without overlooking any opportunities and to try to document such facts. A system for the exchange and mutual supply among tax offices and national tax bureaus of the taxes and public dues collected based on these materials should be established.

The inspection of financial statements and the like based on data files has assumed great importance in preliminary inspections because the inspection of these materials helps greatly in clarifying the advisability of tax inspections and accurately determining tax inspection targets.

While the number of inspection days is limited, transactions of enterprises tend to become further complicated. This being the case, it is very important in effectively implementing inspections to collect data and information while conducting analysis of financial statements. Effective data and information should therefore be collected from publicity information of individual enterprises disseminated through newspapers, magazines, TV radio and other media.

The content of data to be collected and the method of collection should be as shown below:

**1) Statutory data**

The introduction of a statutory receipt system would be desirable. It has been suggested that formation of data files based on legal receipts to be submitted to GDNT be obligatory and that information be collected through this system.

**2) Data collection through tax inspections**

At the time of the tax inspections, besides the inspection target, business partners likely to have undeclared income should also be selected and data files regarding related transaction amounts, content of transactions, trading dates and

other information should be prepared.

3) Data collection from government agencies

Efforts should be made to document government agency data useful in tax inspection, such as data for registration upon the purchase of residence. It would be desirable to try to improve relationships with other government agencies, which are not considered to be greatly cooperative.

### **3.2.7 Improvement of Inspector Capability**

Efforts should also be made to enhance the inspection skills of inspectors through various kinds of training (knowledge of tax accounting, methods of collecting materials for data files and their importance, accounting book inspectability, methods of utilizing tax evidence data and teaching inspection techniques). The excellent achievement study meetings mentioned above should also be held to provide officials who achieved remarkable results with the opportunity to convey their techniques to other officials and permit the sharing of techniques among the staff as common expertise. The study meetings should also be used for the commendation of those officials by the Director General of the GDNT and director generals of national tax bureaus.

### **3.2.8 Identification of Non-filers**

Non-filers should be identified through the inspection of corporate and association ledgers, importer lists of customs bureaus, lists of taxpayers enjoying tax preferential steps and individual tax inspections.

Although the tax inspections described above are relevant to corporate tax, it would also be effective to inspect the introduction of VAT at the same time.

## **Chapter 4**



## **4 Introduction of the Blue Return System**

### **4.1 Significance of the Blue Return System**

The Blue Return System is a system that, through some measures provided for under the tax laws, rewards those taxpayers who fall under the following categories: individuals (self-employed), individuals who are renting or leasing a real estate property (hereinafter collectively as “self-employed”) or enterprises who file tax returns based on ledger records of day to day transactions. Those who qualify to file under the Blue Return System are referred to as Blue Return Filers.

In essence, under the self-assessment system, regardless of the status of being an individual or incorporated, all taxpayers engaged in a business must calculate the income based on daily ledger records and declare the income calculated.

This is defined under the existing Mongolian laws in the General Tax Law Article 9 《Rules of Taxation》 Clause 1 as “taxes shall be assessed based on returns of incorporated enterprises, or individual income tax returns or through withholdings ...”, and in Article 10 《Obligations of the Taxpayer》 Clause 2 “the calculation and reporting of assessed taxes and tax payment shall be submitted to the tax office by the due date.” And in the same Article Clause 3 defines “journals and ledgers shall be kept in accordance with the rules and an accounting report shall be produced”.

In Article 8 of the Law on Supervision of Tax Assessment, Payment and Tax Collection 《Record and Retention of Evidential Documents and Accounting Documents regarding Taxes》 Clause 1 “the taxpayers shall be taxed in accordance with the laws and in order to make clear the tax amounts, he will prepare evidential documents. In the case of incorporated enterprises and institutions accounting documents and in the case of general public, regular records of income and expenditures shall be kept” and further under Article 15 of the same Law 《Submission and Examination of Tax Amount》 Clause 1, it specifies that, “taxpayers shall themselves calculate the tax amounts based on relevant documents and books and specify the amount on the return. ...”.

As specified above, the self-assessment system is adopted for both individual income tax and the corporation income tax in Mongolia and in reporting income, the taxpayers must calculate the taxable income and the tax amount using journals, ledgers, accounting books and other accounting documents. However, the existing system has only been in place for about 10 years and most taxpayers have minimal awareness of taxation and have insufficient accounting knowledge, thus creating an environment in which expecting all taxpayers to maintain ledger documents, making entries and retention (“recording of ledger documents”) all but futile.

Therefore, the Blue Return System should be introduced in order to provide encouragement for even a miniscule increase in the number of taxpayers who file income tax returns based on ledger records and through various measures (such as granting of special benefits or privileges) foster and protect the Blue Return Filers who have opted for the system.

The Blue Return System is extremely effective in reinforcing the acceptance of the self-assessment system.

## 4.2 State of Record of Ledger Documents

In current day Mongolia, judging from the observation of the state of record of ledger documents among self-employed and incorporated enterprises, the foreign affiliated companies or large companies such as the state enterprises maintain record of ledger documents prepared by accountants and prepare financial statements. Among other smaller and medium incorporated enterprises, only a small minority (estimated to be only about 10-20% of the total), maintain record of ledger documents prepared by accountants. In the case of self-employed and others, while they must keep some sort of business memo records, it would not be an exaggeration to say that no ledger data for the purpose of calculation of taxable income exist.

The factors behind such a situation include the following:

- (a) A tax accounting system, in which the tax accountant whose principal function is the preparation of tax related documents, does not exist and the accountants are currently fulfilling that function. Hiring of accountants is limited to only a part of the taxpayer base such as the large companies.
- (b) There has been no transfer of accounting knowledge and skills.
- (c) Of the self-employed taxpayers, those who qualify under the Businesses or Services with Indefinite Income category mentioned later in Chapter 5, (GDNT does not have an exact count of these taxpayers but it is estimated that over one half of the self-employed fall into this category) and as explained, under the Special Law of the Individual Income Tax Law "Income Tax Law for Self-employed Persons engaged in Businesses and Service with Indefinite Income" can fulfill their tax obligations by payments of the standard tax amount. For these taxpayers, books are not required for calculation of taxable income.
- (d) Excluding some large companies, most of the business transactions are cash-based and do not require maintaining complicated bookkeeping records.
- (e) Preponderant proportion of taxpayers suffers from low tax awareness and resists creating or maintaining records that would make their taxable incomes explicit.

### **4.3 Scenario for the Introduction of the Blue Return System**

#### **(1) Timing of the Introduction**

As stated in 4.2 above, except for some large companies, most taxpayers do not maintain any books or documents for the calculation of taxable income nor do they have any particular inclination to do so. Given these conditions, rushing into the introduction of the Blue Return System would not prove to be an effective way of increasing the number of taxpayers who file proper returns based on ledger records.

To review the benefits of the Blue Return System in comparison with the system being utilized in Japan,

- 1) Regardless of whether the subject is an individual or a corporate taxpayer, there are no other examples anywhere in the world other than Japan of a tax system that provides special treatment based on special taxation measures that apply only to blue return filers.
- 2) The most significant benefit for the self-employed taxpayer in Japan is the recognition of expenses for family employers as necessary expenses. Under the existing Mongolian Individual Income Tax Law, however, there is no limitation placed on the salaries paid to family employees or their admissibility as necessary expenses.
- 3) Another benefit available only to blue return filers is the ability to carry net losses both forward and back (refer to 3)(ii)). In order to take advantage of this, however, the taxpayer is required to perform detailed calculations based on a consistent and accurate set of ledger records and this may thus be regarded by the taxpayer as an onus rather than a benefit. These may be thought of rather as extensions of several policy-oriented benefits that are easily comprehensible and readily acceptable to taxpayers such as the special blue return deductions.

To enable the taxpayer to appreciate the benefits of the special blue return deductions and



accept rigorous discipline required for maintaining records in ledger documents, it is necessary to increase the proportion of taxpayers who prepare self-assessed tax returns and for the reported incomes to approach closer to the proper level for the efficacy of the system to be appreciated.

In the case of individual income tax, unless the above Special Law of the Individual Income Tax Law that provides for the standard tax system for business operations and services that generate indefinite income and which is characterized by a notable lack of fairness is amended or repealed, it would be difficult for those taxpayers to whom the Special Law does not apply to have confidence in the tax administration and to accept the introduction of the Blue Return System.

The following must therefore be accomplished as prerequisites for the introduction of the Blue Return System:

- 1) In regard to individual income tax, the standard taxation system under the Special Law must be amended or repealed and for the self-employed, provide strong guidance requiring the calculation of business income and expenses based on ledgers and other records as the basic principle for the calculation of taxable income.
- 2) For both the self-employed and corporations, even if there is a lack of ledger records, the tax administration must devise measures to enhance taxation through the adoption of indirect taxation and conduct tax examinations that would instill an awareness that taxation cannot be avoided even if there are no ledgers and that, furthermore, not having such records could be disadvantageous.
- 3) Ensure the acceptance of the Registration System (which is currently being implemented) and the Statutory Receipt System. Furthermore, ensure the collection and identification of taxation data.
- 4) In order to raise the tax awareness level for all taxpayers, measures such as continuing with the publicity efforts and working to disseminate knowledge and bookkeeping practices must be done in tandem and they system should then be

introduced at a point when a certain level of success has been confirmed.

**(2) Books required to be kept by the Blue Return Filers**

When considering ways of imposing on filers the requirement keeping books upon the introduction of the Blue Return System, business scale, transaction details and their knowledge of maintaining bookkeeping records must be considered since those selecting the Blue Return System would range from small self-employed businesses to large-scale companies. Filers must therefore be classified under one of the following three categories:

1) Those who maintain a proper set of books

- The required books would be journals, general ledgers including supplementary and other ledgers incidental to these, other books as required and inventory lists based on the usual double-entry bookkeeping system that would serve as the basis for the preparation of balance sheets and profit and loss statements.
- Corporations would be required to follow this series of procedures while the self-employed would be allowed to use the procedures with approval based on application.

2) Those who can keep summary books

- Summary books to be kept would be cashbooks, accounts receivable books, accounts payable books, detailed expense books and fixed asset registers.
- Self-employed taxpayers could apply and utilize such methods upon approval.

3) Books on a cash basis

- Accounting for income and expenses would be recognized when recording is based on the timing of actual receipt and disbursement of cash. Cashbooks and fixed asset registers would have to be maintained.
- Only those self-employed persons whose income for the year before last was low (a fixed minimum amount such as 600,000 Tg would be set) would be

approved based on application.

In regard to the required books to be kept in 1), 2) and 3) above, the GDNT would prepare a form that would be easy for anyone to complete. In addition, the GDNT would also need to print and bind the forms to make them available to the taxpayers at affordable prices. An enhancement of the guidance provided by the tax administration is also vital. If possible, it would furthermore be advisable to form a private self-help tax organization perhaps similar to the Blue Return Association in Japan that would enable the taxpayers to work with the tax administration to create a tax environment that would promote the proper reporting of taxes based on ledger records.

### **(3) Special benefits of the Blue Return System**

Though the special benefits of the blue return system are established as policy taking budgetary, social, economic and other current conditions into account, the following can be cited as those of primary importance.

#### **1) Special blue return deductions**

Certain deductions are provided for by law in advance as deduction items in the calculation of business profit in accordance with the type of accounting books.

There is the method, for example, of allowing for differences in deductible amounts depending on the degree of bookkeeping sophistication, such as special deductions of 5,000Tg for those who keep double-entry books, 30,000Tg for those who keep summary books and 10,000 Tg for those who do cash-based business bookkeeping. The positioning of special blue return deductions in this case would be as indicated below when included in a formula for calculating business profit.

$$\text{Sales} - \text{Purchase} - \text{Other expenses} - \text{Special blue return deduction} = \text{Business profit}$$

#### **2) Deductions for net losses carried forward and carry back refunds**

As one special blue return benefit, deductions for net losses carried forward

represent a system that allows blue return filers to deduct such net losses from gains for a three-year period beginning the following year in the event that business profits (sales – purchases – other expenses) for a given year show a loss (income in this case is referred to as net loss).

Likewise, carry back refunds of net losses allow the receipt of refunds of a portion of tax payments by deducting net losses from the net gains of the previous year. Blue return filers would be able to select either the deduction for net losses carried forward or a carry back refund for net losses, as required.

3) Taxation procedures

Benefits would also be available in the procedures used in the taxation of blue return filers, such as, for example, not permitting to estimate taxes without first examining the books or providing blue return filers with written notification without fail regarding procedural actions that have been taken.

4) Other benefits

Various other benefits would also be possible, for example, recognizing bad debt provisions, retirement allowance reserves and various other reserves only in the case of blue return filers or allowing general depreciation expenses by blue return filers for specified machinery and equipment or other assets as well as the posing of special depreciation expenses to necessary expenses.

**(4) Procedures for the Blue Return System**

In addition to the introduction of the Blue Return System, various procedures would also need to be set in place. For reference purposes, the principal procedures would include the following:

1) Blue return approval applications

The Blue Return filers submit a Blue Return Approval Application to their

jurisdictional tax office and the receipt of a Notice of Approval from the tax administration signifies its acceptance.

February 10 (deadline for the submission of income tax filers for the previous fiscal year) of the (fiscal) year for which blue return approval is sought is the deadline for the submission of the blue return approval applications. For new businesses, applications must be submitted within two months after the commencement of business operations.

In addition, applications must clearly indicate the address (address of the individual or the location of the headquarters in the case of corporations, name (individual's name or the name of the corporation and its representative), business category, date of business commencement of individual, date of establishment of corporation, etc., bookkeeping method (selection of double-entry, summary or cash-based bookkeeping) and the type of accounting records that are kept (journals, ledgers, cash disbursement ledgers, sales books purchases, detail expense statements, fixed asset ledgers, etc.).

## 2) Cancellation of blue return approvals

Even if the use of blue returns is approved, the tax administration can rescind such approval in the event later of the falsification of accounting books, if they are not maintained and information is not recorded as stipulated by law or if income tax returns are not submitted by the deadline established by law.

To cancel the blue return approval, the jurisdictional tax authorities would send a Blue Return Approval Cancellation notification to the relevant taxpayer with a clearly worded statement explaining the reason for the cancellation.

## 3) Retention period for bookkeeping records

The required record retention period is seven 7 years for ledgers, financial settlement related documents and cash and deposit transaction related documents and five years for other documents.

## 4) Termination of blue returns

If a taxpayer decides to terminate the submission of blue returns, he/she would

do so by submitting a Blue Return Termination Notification to the jurisdictional tax administrative authorities by February 10 (deadline for submission of income tax returns) of the (fiscal) year following the year of termination.

## **Chapter 5**





## **5 Taxation for Businesses and Services with Indefinite Income**

### **5.1 Raising Issues**

Under Article 7, Clause 4 of the Mongolian Individual Income Tax Law ("Law"), the taxation procedures applicable for self-employed people who are engaged in businesses or services with indefinite incomes shall be determined by the state assembly upon the recommendation of the government. "The Income Tax Law for Self-employed Persons Engaged in Businesses and Services with Indefinite Income" ("Special Law") was enacted by the Mongolian National Assembly and has been implemented.

Under the Special Law, for specific types of industries being operated by individuals, by making a monthly specified tax payment ("standard tax amount") as determined according to the industry type and the region where the business is located, it is deemed to have fulfilled its tax obligations.

Note that in Mongolia, the standard tax amount is referred to as patent fee and the self-employed taxpayer who pays patent fees is referred to as a patent trader.

The intent behind the provision is that the industries covered by the Special Law share the following characteristics and in lieu of calculating income using business income and expenses based upon the accounting and ledger records as required by the Law, a fixed amount is levied as determined according to industry type and regional location regardless of the size of the business.

- (a) All revenue and expense items transacted are cash-based
- (b) Generally tend to serve many buyers
- (c) It would be difficult or unrealistic to expect ledger records based on the proprietor's tax experience and tax knowledge
- (d) Business is small and the income level is also limited
- (e) Considering the administrative burden for the tax administration, there is a need for an efficient method of tax collection.

Essentially, a just and fair taxation under a self-assessment system lies in the determination of taxation from income as calculated from operational income and expenses. However, taxation using standard tax amount under the Special Law sacrifices fairness of tax burden for each individual taxpayer and has placed a priority on the convenience of the taxpayers and the tax assessment agency. As an example, recently due to the type of industry or due to a favorable location, there are increasing numbers of taxpayers who, in spite of realizing high levels of income, have been able to get away with paying a paltry amount of taxes in the form of standard tax amount.

There is some dissatisfaction from some taxpayers about the unfairness of tax burdens and some criticisms have been leveled against the tax authorities' posture in tax collection. An area worth noting is Ulaanbaatar where the patent traders are mostly concentrated. Income disparities between patent traders and non-patent traders as well as among patent traders themselves have widened and unfairness caused by the Special Law and the standard tax amount have become noticeable. As a result, the Ulaanbaatar tax bureau conducted examinations on patent traders who operate passenger transportation services using minibuses and when the patent fees that were being paid were compared with hypothetical taxes calculated based on the calculated net income (partial estimation used), the latter averaged more than 4 times the former for the average operator. There are 1,836 minibuses providing passenger transport services in the city and 535 in the suburbs. Assuming that all of these operators were to be assessed taxes according to the provision under the Law, we would estimate that the annual incremental revenue of 1,087,613 Tg can be realized.

From the above observation, the Special Law relating to self-employed taxpayer should, in principle, be immediately abolished in order to bring about a just taxation under the self-assessment system. However, the following issues must first be considered: (i) whether the system should be immediately abolished, (ii) whether the law could be amended without abolishing it and if it were to be amended, what types of amendments would be desirable?, and (iii) whether it is possible to leave the existing Special Law as is but by an interpretation of the provisions, can those taxpayers who are in conspicuous violation of fairness in taxation principle (those who are realizing high income levels in relation to the patent fees they pay) be isolated and be subjected to taxation under the Law?

## **5.2 Proposals for Dealing with Issues**

### **(1) In Case the Special Law were immediately abolished**

If the Special Law were to be immediately and completely abolished, a voluntary and accurate tax reporting from the taxpayers cannot be expected and it would likely lead to the majority of the individual taxpayers either becoming non-filers or under-filers because (i) self-employed taxpayers, although it can be assumed that they keep some sort of records of their transactions, are not versed in maintaining ledger records and those records that they do keep cannot be expected to be volunteered and (ii) taxpayers seems to lack consciousness of tax payment.

In order to correct this situation, thorough tax inspections of non-filers and under-filers must be conducted as well as remedial measures through indirect taxation must be deployed. Under existing conditions where tax inspectors who would be able to carryout such tasks are limited, it would be near impossible to allocate the required number of inspectors to perform the necessary number of inspections on individual taxpayers. As a result, a reduction in tax revenues would be inevitable.

If the revenues are considered, the existing system of granting of operating permits based on payments of standard tax amount, while this creates unfairness in terms of the size of incomes, brings about some benefits including securing the minimum amount of tax revenues. Further, what may be the most important benefit of the existing system is its ability to involve many small-scale entrepreneurs in taxation affairs and raising their tax awareness level.

However, if the magnitude of the unfairness is limited to relatively small amounts, then it would not be so problematic but as stated earlier increasing number of taxpayers are enjoying high income levels while being able to get away by paying minimal amount of taxes. As a result, this has invited criticisms from other taxpayers as to the system being unfair risking a dramatic decline in the people's level of confidence in the tax system and tax administration and jeopardizing the realization of just and fair taxation under a self-assessment system.

In order to avoid the above scenario, some reform to the existing system must be made.

**(2) In Case the Special Law were Amended**

The following three scenarios may be considered:

- 1) Add industry groupings to the existing group requiring the standard taxation and review the regional grouping criteria and amend the monthly payment amounts to coincide with the existing conditions.

According to the September 2000 Reform proposal submitted by the GDNT, in addition to the 38 types of businesses that are now included in the list, 30 additional business groups including parking lot operators, mortgage lenders and cellular telephone vendors will be added. Within the existing businesses, for 8 types of businesses that have experienced significant increases in incomes, the standard tax amount will be increased from 1.2 times to 8.3 times.

The proposed amendment is intended to expand the scope of the Special Law and make the standard tax amounts more in line with the current realities. However, while it further facilitates assessment and collections and aims for a one-time incremental increase in tax revenues, it will fall outside the gamut of just and fair taxation based on the actual business profits which is the intent behind the self-assessment system. From this point of view, the proposed reform would be looked upon as inappropriate.

- 2) Reduce the numbers of businesses to which the Special Law would apply to and increase the standard tax amount for those businesses that remain to reflect the current realities.

This approach is based on the thought that the self-employed taxpayers should calculate the tax amounts based on the actual income and expenses based on ledger records to the extent possible. From the perspective of the self-assessment system, this would be considered a desirable direction for reform.

- 3) Amend the Special Law such that taxpayers would, in principle, become subject to taxes under the Individual Income Tax Law. The patent traders would continue to make payment of the standard tax amount, however, this payment would be treated as advanced payment of the annual tax which is calculated under the Individual Income Tax Law and the amounts would be settled at the end of each calendar year.

Delete the Special Law Article 4 Clause 5 “In accordance with Article 10 Clause 5. 6 of the Resident Income Tax Law, income arising from businesses or services indicated on the certificate shall not be included in the annual income amounts to be calculated from the assessed list”. Instead, insert “income arising from businesses or services indicated on the certificate shall be determined by calculation of the income and expenses and shall be added to the annual income amount to be calculated from the assessed list. Settlements shall be made for excesses or deficiencies in tax payments.”

This retains the practice of maintaining operating permits based on payments of the monthly standard tax amounts, but under the amendment, the said payments are advance payments for taxes that will be calculated annually under the Individual Income Tax Law and resulting excesses or deficiencies will be settled at year-end. With this amendment, if the taxes calculated based on the Individual Income Tax Law fell short of the amounts that have been paid in the form of standard tax amounts, the differential amount would be refunded to the taxpayer. On the contrary, if the amount calculated exceeded the amounts collected, then the taxpayer would pay the differential amounts as additional taxes.

Even with this amendment, it may be realistically difficult to expect proper tax returns from those taxpayers whose calculated taxes exceed the standard tax amounts. However, this amendment shall accomplish a conversion of the taxation system in which the tax is imposed based on the standard tax amounts to a system based on Individual Income Tax Law in which fairness of taxation can be assured. All that remains is tax administration issues of how efficiently the tax inspections and collections can be effected. The important element is the conversion of the taxation system to conform to the principles of Individual Income Tax Law from

the existing standard tax amounts. Clearly, the amendment clarifies as a point of law that if the actual incomes are excessively disparate from the standard tax amounts, tax administration is empowered to take corrective measures.

By this, in addition to securing the minimum amount of tax revenues in the form of the standard tax amount, the tax administration is enabled to deploy the available inspectors to ensure proper tax assessments for the high-income taxpayers. As a result, unfairness of taxation among taxpayers will be eliminated or minimized and this will lead to establishing the people's confidence in the tax administration.

- (3) Without amending the Special Law, take an interpretation of the existing Law that would make it possible to take those high-income taxpayers and make them ineligible to benefit from the Special Law but subject them to the principles of the Law**

Under this concept, it takes the interpretation that in the case where the application of the standard tax amount as provided for under the Special Law creates a condition that contravenes the real intent behind the Special Law and the fairness of taxation principles, businesses or services that are provided for in the Special Law would no longer be considered businesses or services with indeterminable income as defined under the Special Law and would become subject to the principle of taxation applicable to self-employed taxpayers.

If such tax treatment were to be brought to court, then the tax administration would naturally bear the legal responsibility for the establishment of the following:

- 1) Intent behind the Special Law

The Special Law, as the name implies, exempts businesses with indeterminable incomes by nature from having to calculate incomes based on the actual income and expenses. It enables the fulfillment of tax obligations by a payment of a flat tax amount, namely the standard tax amount. In this case, inability to determine income arises not out of a physical inability as a natural phenomena but simply means that a

proper reporting based on ledger records cannot be expected from the taxpayer due to technical issues such as the taxpayers' insufficient tax knowledge and lack of experience in maintaining ledgers. Thus, it should be interpreted that the businesses, which the Special Law intends to cover, should be limited to those businesses where the applicable participants realized moderate income levels and application of the standard tax amounts would not prove to be a substantial abuse of fairness in taxation.

Thus, in the businesses in which the said taxpayer belong to, if a taxpayer's income level is substantially higher than his peers, and it is deemed that taxation using standard tax amount will result in a significant abuse to the fairness in taxation principle, the Law can be interpreted so as to allow such taxpayer to be excluded from the Law's applicability.

2) Determination of the Income of the Said Taxpayer

The tax administration must then accurately determine the income based on calculation of business income and expenses using accounting books or some other original data. If such income cannot be accurately determined by calculation of business income and expenses, then the tax administration must revert to the use of comparisons with peer businesses, or presumptive taxation methods to determine income. In the case of the use of indirect taxation, the legal basis of the indirect taxation and the reasonableness of the estimation methodology must be established. In addition, a case for the legitimacy of the tax treatment must be made.

3) The income level in comparison with its peers is high and from the standpoint of fairness of taxation, the application of the standard tax amount is unreasonable.

Finally, the tax administration, by establishing that the income as determined in 2) above is substantially higher than that envisaged under the standard tax amount (for example double), will assert that in order to maintain fairness in taxation, the application of the Special Law should not be recognized but taxation under the principles of taxation under the Law should be the legitimate taxation method.

### **5.3 Process Going Forward**

The existing state, related issues and various proposed remedies regarding the taxation of self-employed taxpayers in businesses or services with indefinite income have been discussed above.

Considering the existing state of tax execution, the reforms should progress in the following priorities with the ultimate aim of the total elimination of the Special Law and transition to the principle of taxation under the Law.

- 1) In addition to the amendments reducing the number of businesses to which it is applied, amend the standard tax amount to meet with current realities (method adopted in **5.2(2) 2**)).
- 2) In parallel, from the intent of the establishment of the Special Law and the fairness in taxation (a fundamental principle of taxation), make the Special Law inapplicable to high income earners but force such taxpayers to be subject to taxation under the principles set down under the Law. Even if the court rules unfavorably, by making the unfairness in taxation express, a foothold for reform of the Special Law can be forged (adopted in **5.2(3)**).
- 3) Amend the law to have the standard tax amount as advanced payments for the annual tax amounts and settlements to be made at year-end (adopted in **5.2(2) 3**)).



## **Chapter 6**



## **6 Tax Accounting System**

### **6.1 Tax Accounting**

#### **6.1.1 State of Tax Accounting and Issues**

##### **(1) State of Tax Accounting**

In accordance with the definitions provided for in the tax laws, the practice of accounting for the purpose of calculating taxable income shall be referred to as tax accounting. Tax accounting did not exist before the early 1990's (prior to the economic reforms) and books were kept based on original data.

When the transition to a market economy was initiated in 1992, the Mongolian government began to design a new tax system and undertook sweeping reforms including introduction of a new accounting law in 1993. With the introduction of a new tax system, the taxpayers were now obligated to file tax returns according to the appropriate tax classifications and the need for tax accounting has heightened not only for the taxpayers but also within the GDNT. The GDNT, in order to fulfill the requirements for information processing, is expending its utmost efforts in addressing the issues relating to compliance with the reporting obligations to file tax returns and to improving the quality of the returns submitted by the taxpayers.

The Mongolian Government introduced an accounting system based on the International Accounting Standards in 1994 and mandated the enterprises and other organization to prepare financial statements using accrual accounting principles. However, rules regarding the preparation of tax returns lacked clarity and there are no provisions even in the tax laws as to the choice of system in preparing tax returns. Due to this background, there are tendencies for the officials at GDNT, at times, to require cash based accounting instead of accrual accounting. In many cases both the taxpayer and the GDNT are not aware of the differences between tax accounting and financial accounting. Two-thirds of the staff of the GDNT were educated during the centrally planned economy period, and

for many years had experienced working under the former accounting system. Younger staff, who had been recruited relatively recently, tends to be better equipped with modern skills. Friction frequently arises between these two camps causing a rift in trust between these two groups. As a fundamental methods of resolution, the GDNT has taken the stance that there are three methods: regulation of accounting through tax laws; elucidation of the accounting system within the tax laws and regulation of tax accounting and financial accounting using laws appropriate to each. In another words, financial accounting needs to be regulated by Accounting Law and the tax accounting by tax laws; however, in today's Mongolia none of the above methods are being adopted and no solution has been found for the confusion that this has caused.

On the other hand, the level of expertise in accounting differs depending upon the size of the corporation. Larger corporations have a certified accountant taking responsibilities of accounting and from the overall corporate level ability to process data is not an issue. However, the same may not be the case at a branch office level, where the level of accounting knowledge of those who are responsible for accounting may be questionable. In fact, inter-office accounting system has not been adopted. Also in the small and medium scale corporations in which the number of staff in an accounting function is only a few, there is a disparity in the level of understanding of accounting existing among the persons responsible for the accounting function.

## **(2) Issues**

In the existing organization of the GDNT, tax is assessed by the Taxation Division (Section). The authorities review tax returns, financial reports and other documents submitted by the taxpayers and based upon discussions with the taxpayers determine the tax amounts. GDNT scrutinizes all of the documents submitted in order to ascertain the amount of the income or the losses. If a clear omission is discovered and no amendment is forthcoming from the taxpayer, a reassessment is made after the conclusion of the accounting period. In principle, all returns submitted by the taxpayers are subject to review and re-categorization by GDNT and, if necessary, will be subject to reassessment.

Among the issues that arise in the process of reassessment, we will discuss below some of the more important issues.

- 1) There is a risk of further issues emerging as a result of recalculation of the tax amount during the quarter. The tax returns are filed based on incremental cumulative amounts and there is a possibility that the taxpayer will make appropriate amendments during the following quarter and thus resulting in duplicative taxation. Some such cases are discovered in the course of a year-end tax inspection. This type of mistaken reassessment is a cause for a discrepancy in the inspection results conducted by tax inspectors.
- 2) Normally, the corporate tax return and the VAT returns differ. VAT returns are filed monthly and in comparison with the income tax, are examined with higher frequency. However, the situation is that the sales amounts that are being reported are full of discrepancies and inconsistent returns are being filed. Generally, the sales value reported under the VAT tend to be correct and the tax inspector prepares a written report to reconcile the differences in the total revenues that are reported in the VAT return and the income tax return. Strictly speaking, a report ought to be prepared also in cases where no discrepancy exists and the tax officials at Taxation Division ought to provide direction as to how the differential may be eliminated. Currently direction is only provided when there is an incremental tax that needs to be paid, but this will not be useful in the resolution of the differences between the income tax and the VAT and only provides taxpayers who have submitted erroneous returns an opportunity to evade their responsibilities.
- 3) The taxpayer must prepare the income statements using the same categories that are being used in the tax returns. However, there are cases where, in order to evade taxation, special income that is subject to preferential tax treatment are recorded as supplemental income in the income statement resulting in under-reporting of taxable income. However, in the process of assessing taxes, it is difficult to make a confirmation of the propriety of the basic data. For example, the taxpayer may, in order to under-report customs, falsify invoices or in order to reduce income tax

switch invoices with a higher valued invoice thereby artificially inflating the costs and reducing taxable income. These examples show the lack of cooperation between GDNT and the Customs authorities and as the original documentations have not been properly unified mutual checks at the time of assessment and tax inspections are impeded.

Exploiting the lack of clarity in the accounting treatment and information exchange between the taxation and customs authorities, the taxpayers file returns using differing amounts and invoices or use original documentation that are not supported by the taxpayer identification numbers. In such cases, reassessment would fulfill an extremely important function. However, reassessment under the existing GDNT organization may result in an emergence of functional inconsistencies between the taxation and the inspection sections. When the tax inspector in the tax inspection section deems it necessary to make a reassessment at the time of acceptance of a return, it could be construed as infringing upon the duties of a tax inspector. On the other hand, if no direction is issued, it could be viewed as a dereliction of responsibilities.

The taxpayer has prepared a tax return following the classifications being used in the income statement, in accordance with the tax law and based on the requirements of the tax authorities, thus, he feels no obligation to prepare an amended return. At the same time, the problem may have been exacerbated by the lack of familiarity with the practice of accounting under the International Accounting Standards and by the inadequacies in the supervisory organization. Although Aimag, cities, and districts are in receipt of financial documentations from enterprises and organizations under their respective jurisdiction, there is still insufficient awareness of the practice of requiring recordation and consolidation of financial statements in accordance with accounting standards. Many managers of enterprises look lightly on maintaining records consistent with the accounting standards and on performing business analysis utilizing accounting records.

Taxpayers are currently being required to submit 18 different types of tax return forms. Based on these forms the Information Statistics Division compiles 45 varieties of statistical documents. Following is a summary of the accounting relating to the principle forms of taxation.

**Incorporated Entities and Organizational Income**

In the current practice, incorporated entities and organizations submit tax returns and calculate the deductible expenses and liabilities using data from sales book, income statement and related general transactions. However, many of the taxpayers have been less than diligent in the maintenance of accounting records and the collection of original documentation and this has a deleterious effect on the accuracy of the tax returns. There are some areas where the procedures dictated by International Accounting Standards and the domestic tax laws are inconsistent, and some adjustments will need to be made in order to summarize a part of financial accounting to tax accounting. Relating to this, there are issues being raised in the preparation of tax returns for incorporated entities and organizations. Taxpayers fail to recalculate the taxable income from the net income in the “financial statements and tax return discrepancy adjustment return” using management accounting and cost accounting or if it is being performed it is being performed incorrectly. Because there is a lack of awareness of the correct methodology that need to be used in making the adjustment and a lack of awareness of its importance among the taxpayers and some of the tax officials, proper returns are not being filed. Most likely, the discrepancy adjustment return not properly reflecting the discrepancy adjustment calculations, incorporated entities not maintaining extensive records or the adjustment return bearing little relationship with incorporated entity or organization tax returns are somehow inter-related.

**Individual Income Tax**

In accordance with the Individual Income Tax Law, employers who pay wages to employees and workers, at the time of disbursement of wages, withhold from wages amount equivalent to the tax amount and submit withholding tax returns. In order to prepare such returns, details of wages, cash ledgers, and other related documents must be kept.

Individuals who are self-employed calculate their own income and taxes and submit self-assessment return to the tax authorities; however, the reality is that GDNT has no capability of enforcing compliance of tax laws. Even if they had the capability, there are not many taxpayers who understand the calculation methods used in the derivation

of taxable income. This is due to the lack of development of the taxpayer education and although it may be roundabout, education and publicity campaigns need to be mounted using guides and publications.

Wage payers must pay the taxes withheld to the tax office within the time specified and submit a monthly return by the 10<sup>th</sup> of the following month. Self-employed persons must maintain abbreviated records and calculate taxable income each quarter and pay taxes by the 15<sup>th</sup> of the month immediately following the close of the quarter. Individuals settle their taxes each year by February 10<sup>th</sup> of the following year. However, individuals who are self-employed rarely use this method of taxation but rather most pay a monthly flat tax which is set according to the industry in which they belong under the "Presumptive Tax Law" and get away paying lower taxes than the amount that they would have rightfully paid under proper income taxation. The existence of this law has increased the sense of inequity felt by the incorporated entities. As a result, some incorporated entities are dissolving their incorporation status in order to avail themselves to being taxed at flat rates. It must be pointed out also that this is also an issue for tax revenues..

#### **Value Added Tax (VAT)**

VAT taxpayer is required to document each transaction with original documents and each time a sale is recorded he is required to issue invoices with the VAT amount. In order to calculate the VAT, a sales book and procurement records must be kept and the taxpayer must categorize in such records according to the applicability, exemption of VAT or export or import. VAT taxpayer must pay the VAT relating to the product or service by the 15<sup>th</sup> of the following month. The collection of VAT related to imported products is, with the collections of tariffs, in the hands of the customs authorities. And monthly tax returns must be submitted to the Ministry of Finance by 10<sup>th</sup> of the following month and year-end tax returns must be filed by the 15<sup>th</sup> of January of the following year.

However, for the persons who are self-employed, as the sales amounts are not identified under "Presumptive Tax Law", rarely pay taxes.



With respect to issues in tax accounting, it is necessary to conduct taxpayer education. As one of the principal reasons for the dysfunction of tax administration is attributed to the practice of bookkeeping not being widely spread and the lack of understanding on the part of the taxpayers can be raised. Consideration must not be limited to only taxpayers but considerations must also be given to the situations surrounding GDNT.

GDNT has been pressured by the need to construct an accounting system for its use. It is important that enhancement of the GDNT's management and organization, upgrading the skills of the management staff and on a long-term basis reform of the tax system are undertaken.

#### **6.1.2 Recommendations for Dealing with the Important Issues**

- 1) Installation of accounting, information and supervisory systems to support the planning, monitoring, analysis and clarification of tax system within GDNT
- 2) Establishment of an extensive training program to heighten taxpayer awareness of the differences between the financial and tax accounting and the importance of maintenance of records consistent with the International Accounting Standards
- 3) Holding of staff seminars covering the above items
- 4) Clarification of accounting principles to be applied in tax accounting in the tax law and spelling out specifically the calculation method for the derivation of taxable income.
- 5) Transition of the system to create expense details at the same time as tax returns.

The above five points will be items requiring attention going forward. There is, of course, a necessity of an establishment of a tax accounting system in Mongolia but it can only be realized with the maturing of the tax laws and the organization within the GDNT becoming ready when it is complemented with qualified staff. At this stage, achieving enhanced capabilities relating to the prerequisite, tax accounting, may need to be given precedence.

For example, although there are some differences in the way of calculating the taxable income between the corporate taxation for incorporate entities and organizations in Mongolia and under corporate taxation in Japan, so long as the taxpayer has a general

knowledge of accounting, tax collection should become relatively straightforward. It is clear that in many cases, among taxpayers, there is lack of appreciation for the importance of tax accounting based on accounting principles that are generally deemed to be fair and appropriate. Those who, until a decade ago, were educated under a socialist and centrally planned economic regime and working under the old accounting system are not limited just to GDNT staff. Taxpayers, the Mongolian people, had little need for accounting systems. Also giving consideration of this, GDNT in order to conduct tax administration in a more rational and efficient fashion, needs to develop measures to deepen the taxpayers' understanding of financial accounting.

Although some differences exist, the income tax for the incorporated entities and organizations in Mongolia, like the Japanese corporate tax, is a tax on income. In Japan when a modernization of the corporate accounting system was called for and its unified improvement was required after the war, Financial Accounting Standards for Business Enterprises ("the Standards") was introduced. The Standards states in the introduction that it aims to improve the current state where accurate assessment of corporate financial conditions and managerial performance was difficult, due to a lack of uniformity in comparison with western models. Furthermore, it also defines its objectives as the introduction of foreign capital which was necessary for the rebuilding of the economy, the rationalization of companies, the establishment of fairness in taxation, to democratization of securities investment, and the creation of a reasonable industrial financing system. General principles enumerated in the beginning of the body, are comprised of 8 items; Truthfulness, proper bookkeeping, materiality, capital transactions and profit/loss transaction classification, clarity, continuity, principle of conservation and principle of uniqueness, and forms the guiding principles for accounting treatment. The principle for proper bookkeeping provides for the preparation accurate accounting records for all transactions, consistent with the principle. The fulfilling conditions for this Principle are considered to be exhaustiveness, verifiability and orderliness and in order to prepare a proper financial statement consistent with this law, it directs the records to be kept using a double entry bookkeeping system.

Therefore, a consideration should be given to recommending ways to introduce and spread double-entry bookkeeping system in Mongolia and maintenance of books and records including preparation of financial statements and general ledgers. In more concrete term, in

order to spread the knowledge of bookkeeping widely among taxpayers, graduated textbooks similar to the Nissho Bookkeeping Level I, II and III needs to be prepared. With this in mind, an introductory level textbook of accounting will be presented as a sample.

In the next field survey, we would like to initiate the study by examining what kind of accounting systems are being used by taxpayers including enterprises. If the taxpayer awareness is heightened and the bookkeeping system becomes accepted, such tax laws as the "Income Tax Law for Self-employed Persons Engaged in Businesses and Services with Indefinite Income" would be amended and the sense of inequity among the taxpayers will be redressed. Further, it would improve the quality of tax returns, and it would enable effective usage of records in the examinations and statistics in the GDNT.

### **6.1.3 Significance and Objectives of the Introductory Accounting Guide (Sample)**

This sample textbook is an introductory level meant for those who have no prior knowledge of bookkeeping. Bookkeeping appears to give the perception of being a very esoteric subject but the textbook is prepared with a view that once the textbook is read, bookkeeping is in fact quite easy to comprehend. Understanding of bookkeeping is not just for accountants in corporations but managers of corporations regardless of the size of the corporation, requires such knowledge in order to understand the accounting conditions of the corporation. It is also important information for those who operating individual proprietorships. Understanding of bookkeeping is essential in determining the profitability of the business and making judgements as to the viability of the business under current method of management using statistical data.

Bookkeeping can be roughly categorized into commercial bookkeeping and industrial bookkeeping. This introductory course of textbook is introduced for acquiring basic understanding of general commercial bookkeeping. Going forward, it would be desirable to consider publishing intermediate and advanced courses based on this introductory textbook as the foundation to raise the level of understanding and consciousness of taxpayers.

## **6.2 Tax Accountant System**

### **6.2.1 Current State of Introducing a Tax Accountant System into Mongolia**

In Phase I, we proposed the introduction of a tax accountant system, and in the current phase, we explained that the introduction of the system will lead to the enhancement of morale among tax officials, and that it will also be indirectly conducive to improving returns by taxpayers. In connection with the tax system reform in September 2000, we recommended the simultaneous introduction of a tax accountant system. As a result, the tax system amendment bill created by the GDNT called for the legalization of the system in SECTION 4 “Agent Tax Accountants” in the General Tax Law. However, in the legal amendment enacted by the national assembly, no such system was introduced.

Hereunder, this mission will explain the state of tax accountants and certified public accountants in Japan and the U.S. for reference. While presenting our views on the positive effects of the introduction of a tax accountant system into Mongolia, we will again propose the institution of the system in the portions of explanation about individual clauses in the Tax Accountant Law.

### **6.2.2 Certified Public Accountants (CPAs) and Tax Accountants in Japan and the United States**

#### **(1) Current State in Japan**

##### **1) CPA (Certified Public Accountant)**

General test subjects are bookkeeping, financial statements, cost calculation, audit theory, the Commercial Code (all of these are obligatory subjects), business administration, economics and the Civil Code (two subjects are to be chosen from among these three) for a total of 7 subjects. If an applicant successfully completes these tests, he/she becomes an assistant accountant. After undergoing actual work

training, he/she sits for the final tests on several subjects, which includes a subject on taxes. The tax topic is corporate income tax. Because the simultaneous passing of these tests is a premise, most of the successful test participants are university students or non-working university graduates.

The principal functions of a CPA consist of the audit or verification of financial statements, adjustment of financial statements and other accounting audit work. Accounting audit by a Japanese CPA is mainly composed of the auditing (based on the Commercial Code and Securities and Exchange Law) of corporations listed on stock exchanges, or non-listed companies capitalized at more than 500 million yen or having total liabilities of 20 billion yen. In other words, their audit subjects are principally major companies. Currently, audits are being carried out based on Japan's own accounting standards, but audit practices are gradually shifting to the international accounting standards. Financial statements have thus far been mainly based on tax law standards, but because of the introduction of the international accounting standards, future account handling may not be based on such tax law standards. A CPA checks if a company performs accounting in accordance with accounting standards or if the accounting meets with the laws, such as the Commercial Code. The CPA has an obligation to verify appropriate accounting is being performed for external investors.

Today, there are about 12,000 CPAs in Japan. (Note that the total Japanese population is about 120,000,000.)

## 2) Tax accountant

The test includes 2 accounting (bookkeeping theory and financial statement theory, both of which are obligatory subjects) and 9 tax law subjects (Corporation Tax Law, Individual Income Tax Law, Inheritance Tax Law, Consumption Tax Law and etc.) To obtain the qualifications, it is necessary to pass tests on 5 subjects that include either the Corporation Tax Law or the Individual Income Tax Law. As for the two remaining tax laws mentioned, selection is left up to the test participants. Because those who seeking to become tax accountants often work for tax accounting offices,

separately passing individual subject tests over a period of time is acceptable. In other words, applicants are not required to pass the tests on five subjects in one sitting, and, as such, they can obtain the qualifications if they pass the necessary tests over several years. Those who can obtain qualifications include successful test participants and those who are exempted from undergoing the tests (specific officials of the GDNT), as well as lawyers and CPAs, who apply for tax accountant licenses. Former tax officials who registered as tax accountants after their retirement have accounted for a considerably high proportion since the introduction of the tax accountant system.

Activities of tax accountants include tax agency work, preparation of tax documents, and tax consulting. In principle, their activities are monopolistic. They also implement bookkeeping agency work, which accompanies the other activities. Accordingly, even a CPA cannot engage in these activities, unless he/she has been registered as a tax accountant. Corporate income tax is included in the test subjects for CPAs, but with regard to other tax laws, it is difficult for a CPA to serve as a tax accountant unless such CPA studies on his/her own initiative.

In Japan, the other parties of contracts are clients – corporations or individuals – in either case of tax accountants or CPAs and these clients are billed for these services rendered. Payment is the responsibility of the corporation or individual. Of course, such disbursements are recognized as expenses under either financial accounting or tax accounting.

While the primary role of CPAs is the audit of accounting work in major companies, function of tax accountants is the audit of the tax affairs of small and medium-sized corporations, as well as of individuals (hereinafter collectively referred to as “small and medium-sized corporations”). Although small and medium-sized corporations have accounting managers, very few of them can do such work as the preparation of financial statements, so most small and medium-sized corporations rely on tax accountants for the preparation of financial statements. As such, tax accountants who make journal entries or bookkeeping on behalf of small and medium-sized

corporations usually prepare the tax returns. Taxpayers who cannot perform bookkeeping are able to smoothly make tax returns through the intermediation of tax accountants, and because tax accountants also serve as agent for negotiations with tax authorities, taxpayers can save superfluous time and focus on their primary goal of operating the business.

There are about 60,000 licensed tax accountants.

## **(2) The Current Status in the United States**

### **1) CPA**

Test subjects are four: Financial accounting and reporting; taxation, management accounting, and governmental accounting; business law and auditing. Thus, the test subjects include non-tax items. The primary function of a CPA is conducting accounting audits.

### **2) Enrolled Agent (EA: U.S. tax accountants)**

Test subjects are individual income tax; sole proprietorship and partnerships; corporations, estate and gift tax and trusts. As such, all subjects are related to the tax laws.

Although the scope of work of EAs (which basically means registration agents) is somewhat different from Japanese tax accountants, EAs may be regarded as tax specialists, because they are exclusively engaged in tax accounting activities. In the U.S., those who can serve as taxpayers' agents in relation to the Internal Revenue Service (IRS), which is in charge of federal taxes, are limited to attorneys, CPAs, and EAs (although Enrolled Actuaries may also serve as such agents under certain conditions). As can be learned from the test subjects, even CPAs must study on their own regarding tax laws not in their specialized fields.

**(3) Difference between Japanese Tax Accountants and U.S. EAs**

1) Preparation of tax documents

Such documents can be prepared only by tax accountants apart from the taxpayers themselves in Japan, but in the U.S., anyone can do it irrespective of whether or not such person holds any legal license.

2) Litigation regarding taxes

In Japan, tax accountants have no authority to attend court hearings (although legal amendment enabling them to do so is being pushed for), but EAs can engage in litigation activities in federal tax courts if he/she can pass the U.S. Tax Court Examination.

3) Continuation of qualifications

In Japan, the qualifications given to tax accountants are permanent, but in the U.S., EAs must continually undergo specialized education and follow the renewal procedures.

**(4) Japanese CPAs and Tax Accountants**

Under the disclosure system, major enterprises are obligated to reveal their financial statements, etc., to the government or shareholders. CPAs conduct audits and certify the appropriateness of such information. Currently, economic globalization is progressing substantially, so enterprises in various countries are promoting mergers and tie-ups beyond national borders with a view to attaining business scale expansion for survival. This being the case, it is not sufficient to consider the tax laws of a single country, and in many instances, a point of view surpassing national boundaries is expected. Investors, such as shareholders, carefully check if such corporate information is reliable. The basis for such reliability is the clean audit certification by a CPA. Furthermore, a CPA also executes management adviser service (MAS) and carries out research and planning related to taxes. Regarding tax declarations, major enterprises prepare them by themselves or ask tax accountants to do so on their behalf.



Under the Certified Public Accountant Law, CPAs cannot implement tax declarations for companies that they have audited.

Although small and medium-sized enterprises carry out business transactions with overseas companies, their business is mostly concerned with domestic transactions. In many cases, their shareholders are limited to relatives and information disclosure is not considered to be an issue. Since no audit by a CPA is required, financial statements may be posted based on the tax law standards, so that it is sufficient to only consider the tax laws of the country concerned. However, small and medium-sized enterprises have few personnel versed in tax laws. Therefore, they seek advice from tax accountants who understand well daily accounting and tax affairs. Legally, tax accountants are neutral, not particularly belonging to the side of the tax authorities or taxpayers.

As for the number of qualified personnel, the number of tax accountants is naturally larger than that of CPAs, because small and medium-sized enterprises number much more than large companies.

### **6.2.3 Significance of the Introduction of a Tax Accountant System**

We consider the introduction of a tax accountant system into Mongolia meaningful for the following reasons.

First, establishment of the system will serve as a step to improve the consciousness of tax officials. The creation of the tax accountant system will lead to economic and social assurance for tax officials after their retirement from tax collection service. After the establishment of this system, tax officials will be able to engage in their tax administration activities while maintaining hope for their future. Depending on the case, even if their salary levels cannot be raised remarkably as suggested above, tax officials may be able to deal with difficult tasks, having an expectation of better conditions in the future and endure the unfavorable economic environment. The proposed tax accountant system is a setup

under which GDNT holds national tests, and successful test participants who are subsequently engaged in the handling of tax affairs and accounting work for a specific number of years are given tax accountant licenses. By adopting the arrangement of exempting tax officials from sitting for the tests, depending on the number of years of their service in the tax collection organizations, these tax officials should be allowed to become tax accountants soon after their retirement.

Second, this tax accountant system is considered to not only provide future assurance for tax officials but to also serve other purposes in Mongolia. Namely, it will prove helpful in breaking out of the current situation under which the bookkeeping accounting system has not yet taken root among Mongolian taxpayers, which is a source of extreme difficulties for the tax administration of the GDNT. If tax accountants, who are experts in tax affairs, bookkeeping and accounting are involved in all taxpayer activities relating to tax returns and tax payment, based on requests by taxpayers and while receiving remuneration from such taxpayers, it will result in the reinforcement of the nation's revenue-collection activities. Because of the involvement of these specialists, tax declarations by taxpayers who do not understand taxes or who have no knowledge about bookkeeping and accounting are expected to significantly improve, resulting in substantial increase in tax revenues of Mongolia. Furthermore, when tax accountants are involved in taxpayers' activities, they are virtually performing the same functions as conducting guidance and publicity on taxes, bookkeeping, and accounting. By guiding and supervising these tax accountants, GDNT will be able to indirectly guide and educate taxpayers. If these effects were converted into cash, the amount would be immeasurable.

As explained above, the tax accountant system is a highly beneficial system, so GDNT should promptly decide to adopt the system and implement efficient tax administration based on such system.

## **Chapter 7**



## 7 The Investigation System

### 7.1 The Objectives of the Investigation System

A compulsory tax inspection shall be performed against certain taxpayers who have been deemed to be guilty of having breached the tax laws. This is the criminal investigation system and its ultimate objective is to secure the tax payment duly owed to the government. The composition of the system will vary depending upon whether the aim is to secure tax payments through the mandatory tax inspection process itself or through the deterrent effect of the threat of criminal prosecution.

Mongolia can certainly select a system that coincides with popular sentiment, but the method adopted by Japan, which is based on the principle that “punishing one will serve notice to all the others” would likely be the more appropriate choice for Mongolia. This system is not to ignore the direct tax securing effect of an investigative activity. Rather, it aims to achieve the same end result through more of a publicity effect. It does not mean a large-scale prosecution of 6,000 cases in a given year or a high profile mass media oriented target selection. Rather, an investigation system that would be the underpinning of the tax administration that relies on steady and persistent activities would be desirable. Reasons for this include the followings:

- (a) Taxation in Mongolia has a very short history. The taxpayer’s level of awareness is low and the sense of guilt associated with tax evasion is almost nonexistent.
- (b) Therefore, even in a general tax inspection, the taxpayer’s level of tolerance is low.
- (c) Under these circumstances, there is a danger that a mandatory tax inspection will invite taxpayer’s resistance. In addition, a large-scale investigation may result in distrust of the tax administration.
- (d) Nevertheless, even if a mandatory tax inspection is resorted to, something must be put into effect to deter the proliferation of the acceptance of the notion “taxes can be evaded and if you don’t try, you lose out”.

- (e) Thus, an investigation system that will target those who are highly organized and whose selection would be accepted as being deserving would be appropriate.

## **7. 2 Overview of the Investigation Operation and General Comments on the Organization**

Investigation can be broadly classified into two activities: “collection of information” and “execution of the inspection”. In other words, it is consisted of seeking out those businesses that ought to become targets for the investigation (information) and actually carrying out the inspection (implementation). Both are wheels of the investigative process and both are equally important but because the roles that they assume differ, each should be organized separately within the investigation organization. Points for consideration are highlighted for each section.

### **(1) Information Section**

The mission is to determine clandestinely a target for the investigation. In order to achieve this, developing and securing information sources are important tasks. It must be noted that due to intelligence’s requirement to conduct covert operations, special considerations need to be paid to many sources. The following classifies the different types of information obtained along with the appropriate considerations.

First type is obvious. It is information that surfaces from the general tax inspections. This type of information should naturally find its way to the Investigation Division within the same GDNT. Setting aside the need to clear the issue of confidentiality (which, by the way, appears to be a non-issue as it is likely that with subtle approaches made by the Investigation Division to the General Taxation Division, such information would be forthcoming), the bigger issue is the prevalent feeling of mutual non-interference. To put it more bluntly, unless there are rewards associated, information cannot be had (let us list

in a random fashion some examples of what might be rewards – a system in which there is recognition to the information provider or whistle blower in terms of job performance evaluation including a commendation system, establishment of an information coordination structure with a relatively high ranking officer in charge, provision of suggestions that may be useful in business management and etc).

Second type is information from third parties. Cases of whistle blowing or internally sourced information that have direct impact are common. A budget to expend to obtain such information is necessary. With the assumption that the popular sentiment would allow it, a “reward system” for information would be effective. Further, if one were to take a long-term view approach, there are sources within the media that can be mobilized. Although generally the value of information is in its freshness, in some cases, value may be borne from accumulation.

## **(2) Executing Section**

This is the section that actually carries out the inspection against the accused. According to the objectives cited above, the primary objective is to effect criminal prosecution but unless a guilty verdict is handed down after deliberations, the responsibilities laid on the investigation will not be fulfilled. Therefore, there is a need to ensure that the prosecutor’s task is facilitated after the indictment, thus, even in the process of investigations, one must always take into consideration the need for an accurate inspection by following the prosecutor’s instructions and establishing a relationship based on mutual trust.

The cooperative relationship between the Executing Section and the prosecutor’s office must not be limited to the one cemented through accumulation of case histories. Tax evasion is different in nature from other types of crime. It exists within an environment whereby the tax evader believes getting caught was a result of his own misfortune and condoning of such a sentiment on the part of the general taxpayers pervade. Therefore, a

steady and unrelenting effort to imprint the idea that tax evasion is indeed a crime would be hoped for. In addition, new safe guarding techniques must be formulated and keeping a watch over the prosecutor's office must be kept to ensure standards are met at all times. This may be off on a tangent, but in the same vein, efforts to cultivate the entire legal profession (not just the prosecutor's offices as sympathizers), the entire academia (should consider establishing a forum for the study of taxation law) and in some cases, making approaches to the mass media (including strategic information leaks where appropriate) should be considered.

### **(3) Some Concrete Comments on the Investigation Organization**

#### **1) Should be a specialized and dedicated organization**

It would be desirable to have the Investigation Division specialize exclusively on the inspection and indictment of tax evaders. For example (taking an example out of the existing system in Mongolia), it would not be conducive to take a person whose main responsibility is to conduct audits to uncover internal irregularities and expect the same person to be efficacious in another post, which, to an extent, relies on the good will of the general tax staff. Auditing function should be located in another area such as the Secretariat. In many cases, the collection of taxes requires different sensitivities from that of tax assessment. It would be more effective to have the department that has the necessary authority to conduct the investigations.

#### **2) The staffing should be comprised of the most able**

Considering the importance and the difficulties involved in the investigation, the people responsible for investigations should be the most capable staff available. For example, for the Information Section, a person with intuition should be selected, while for the Executing Section, a person who has persuasion skills teamed with people who excel in inspections and endurance should be selected to



fill the posts. To coincide with these appointments, each section staff should be made aware of the criteria used in the selection process to raise and maintain the morale of the staff.

3) Develop the core staff as soon as possible

Tax inspectors, in comparison with other types of criminal inspectors, have experience in far more complex inspections and once the basics of criminal procedures are learnt, the inspector will have no concerns in conducting investigative operations. If, for example, personnel interactions with the legal authorities are arranged in the field, personnel who will become the nucleus of investigative case process can be developed within a relatively short period of time. (Note that criminal procedures can be learnt relatively easily, but the absorption of tax investigations will require a longer experience base. Therefore, the interaction will have a focus on the tax inspectors picking up criminal procedures). Once this is accomplished, these staff would become the leaders of several teams that will conduct investigations in an organized way. However, for a period of time, the trained staff will need to be dedicated to investigations. At the same time, a system must be established that will instill the concept for the general tax staff that the provision of information to the Investigation Division is in the natural course of performing his duties (for example, establishing a reporting system with a commendation system in place). The establishment of this system will also improve the appreciation for the investigative function as well as uncover staffs who wish to participate in this type of function. For short, it would have the result of expanding the breadth of investigations.

4) Establish criteria whereby the target for investigations can be focused on

Establishment of criteria for the selection of investigation targets should be considered as a practical approach for the operation of the investigation system. Within the tax administration, the investigative function is an area in which

arbitrariness has no place. Prevention of such is the first step in establishing the trust of the general taxpayer and in order to accomplish this, a standard against which the elements of tax evasion such as the form, amount and etc. can be judged and the target for investigation and indictments can be selected must be established. Setting the criteria will be an effective measure to achieve this.

## **Chapter 8**



## **8 Tax Disputes**

### **8.1 Current State of Tax Disputes and Problems**

Many of the tax disputes that are brought up by tax administration in Mongolia relating to tax assessments, inspections or tax collection are defeated in the courts. There have even been cases in which taxpayers did not observe the deadline set by tax law or who violated provisions of the law – that is, cases in which the taxpayer would normally have been repudiated in a court – and have subsequently brought tax disputes to court with the tax administration ultimately defeated in the trial. An analysis of this situation reveals a number of reasons for this.

It can be pointed out first that the authority of tax officials of the GDNT and all of its subordinate organizations is excessively limited. For instance, even if these officials were to discover a tax evader and determined amounts of tax evasion as the result of an inspection, the officials would be unable to forcibly seize assets of the tax evader except bank deposits unless approval of the tax evader himself or the court is obtained. In addition, these officials are not given the legal right to impose standard tax amounts on enterprises that do not declare their revenues despite their being engaged in business activities.

Second, court judges in charge of lawsuits lack sufficient knowledge regarding tax issues. It has been pointed out that there are tendencies for these court judges to hand down judgments favorable to taxpayers and that taxpayers sometimes successfully bribe judges and it is judged that democratic maturity is insufficient in the trials themselves.

Third, the qualitative level of tax inspections is low. It is possible to surmise that the low quality of the inspections is the reason for the inability to refute the contention of taxpayers in court or to collect evidence to maintain a favorable position in trials.

Thus, as problems, we cannot help but point out that Mongolian tax officials do not have the legal authority that they should have given their responsibility for the collection of taxes, courts do not operate appropriately in judging the reasonableness of administrative

procedures and officials lack the ability to secure the evidence that would allow them to obtain favorable court rulings.

Steps for improving the legal sector, premised on the above, are as follows.

## **8.2 Proposals of Measures for Improvement in Tax Disputes**

- (1) The legal authority of the tax collection organization and tax collection officials should be expanded and vague legal provisions should be eliminated.**

Their legal authority under the General Tax Law, Article 24, and the Law on Supervision of Tax Assessment and Payment and Tax Collection, Articles 17 and 36, in particular, should be expanded. Furthermore, “principles for real tax imposition and collection” should be instituted in the General Tax Law.

Most of items requiring amendment in the Tax System in Part II, including the aforementioned provisions, would probably serve as specific examples for achieving improvements in tax disputes if seen from a different point of view. The explanation of each item should therefore be studied closely.

- (2) Ability to secure evidence should be improved.**

Before bringing suits against taxpayers in court, it is necessary to collect sufficient evidential documents in accordance with the Litigation Law. Nevertheless, in the course of taxpayer inspections, inspectors are frequently unable to calculate the actual taxable revenues of taxpayers based on facts because there are no accounting books, records or vouchers, because no record is kept when transactions occur or because records are insufficient when they are kept. Therefore, since inspection results are determined based the imprecise formula currently being used for standard tax imposition, evidence ability is inadequate, presumably making it difficult to maintain favorable positions in court. In other words, the prevailing situation is a persistent shortage of

evidential documentation that renders it impossible to judge if tax returns by taxpayers are appropriate. This being the case, it is presumed that tax inspection work of the inspectors is difficult and that they will eventually have to adopt a formula of standard tax imposition. However, there are undoubtedly also those cases in which the situation is due to the insufficient inspection capabilities of the tax officials. As a consequence, it is believed that there are a considerable number of cases in which, although factual evidential documents of taxpayers exist, tax inspectors are unable to grasp them.

Accordingly, tax inspectors must carry out daily tax inspection based on their relationship to actual fact and based on real evidence regarding the taxpayers and they should point out unjust or excessively small declarations by taxpayers only when such accusations can be substantiated by real evidence that is already ascertained. If the use of a standard tax imposition formula is unavoidable, tax imposition should be enforced based on a formula that would enable success in winning of lawsuit, and the GDNT should promptly undertake the inspection of such a formula. In connection with this, we propose "Presumptive Taxation" in Chapter 2.

If the "statutory receipt system" were instituted, data acquired thereby would have strong potential as evidence. For this reason, if litigation were carried out with statutory receipts used as evidential data, there would probably be few cases of defeat in disputes under normal circumstances.

**(3) The functions of the Tax Dispute Resolution Council should be expanded.**

Disputes should be handled by the Tax Dispute Resolution Council only after detailed study-based on the assumption that a lawsuit will follow. If premised on the subsequent lodging of a lawsuit, it also would be necessary to include officials in Justice of Ministry or court judge as a permanent member of the Council. That is because these permanent members examine the handling in the Council from the beginning and, in the event of subsequent court proceedings, the possibility that the state would lose a court battle would infinitesimally small. An examination of legal steps to realize an expansion in the functions of the Tax Dispute Resolution Council should be undertaken

promptly.

- (4) The GDNT should promptly organize a permanent consultative committee with judicial authorities (specifically, the Ministry of Justice and the Supreme Court).**

As stated above, there are a variety of reasons for the frequent loss of tax administration lawsuits by the GDNT. The most important reason, however, is more than likely differences in general and individual interpretations, views and perceptions of legal provisions and the execution of various tax imposition practices between the GDNT and judicial authorities. The formation of unified interpretations, views and perceptions of such disparities should be facilitated by promptly establishing opportunities for working discussions of these differences. If judicial authorities do not willingly consent to the establishment of such a consultative committee, the government should study the possibility of establishing a tax court.



## **Chapter 9**



## **9 The Tax Officials Corruption Prevention System**

### **9.1 Problems of Tax Officials Corruption**

It is a well-known fact that the various types of corruption in which tax officials are involved, including the acceptance of bribes, have become rampant. Dishonest practices by tax inspectors, in particular, are believed to be at an extremely high level.

The principal form of corruption is considered to be the reduction of the imposed tax amount due to the acceptance of bribes. The most important reason for corruption among tax officials, needless to say, is the small size of their salaries followed by a lack of ethical principles. When tax officials who receive very low salaries are in constant contact with taxpayers (who always have cash on hand to do jobs) to collect money in the form of taxes, there are undoubted many occasions when they are actively tempted by taxpayers with bribes, not to mention their own willingness to accept them. Under this state of affairs, it is extremely difficult to try to stop the expansion of corruption by simply seeking to improve ethical principles among tax officials. Therefore, in order to prevent corruption among tax officials, steps should be studied to raise salaries of these officials while also considering the improvement of their ethical principles.

## **9.2 Proposals for the Prevention of Corruption**

### **(1) Increasing the income of tax officials**

The expansion of corruption is considered to be unavoidable unless the present income level of tax officials is raised. This has given rise to the important issue of how to go about increasing the income of tax officials, whose salaries are fixed within the salary scale of public employees. Any solution to this problem would naturally have to be substantiated by legal propriety.

As a specific step for improvement, one suggestion would be to amend Article 27 of the General Tax Law for the time being to include a new provision: "The Government Department of National Taxation may use penalties and additional taxes paid as a result of tax inspection, etc., as a special budget." If the addition of this provision would enable the GDNT to secure penalty amounts and additional tax amounts obtained as a consequence of tax execution by its entire tax collection organization apart from its usual budget, tax officials would have more money available to them as these amounts increased. Tax officials would then probably tackle their work with a more enthusiastic attitude, while corruption would dwindle.

The introduction of this system for the time being would probably result in fewer problems in Mongolia at the present time than those revenues in the form of corporate income taxes and interest taxes that would not be paid to the government because of the corruption of tax officials. If this system were introduced, the GDNT should then distribute the budget amount obtained thereby fairly to the tax officials. This means that steps would have to be devised to establish an appropriate distribution system under which additional salaries would also be provided to those officials who do office work and that the additional budget would eventually be divided among all tax officials. Furthermore, tax officials who performed exceptional service through success in increasing such penalty amounts and additional tax amounts would be rewarded through special salary increases. It would not be advisable, however, to give them a certain proportion of the penalty amounts or additional tax amounts obtained by them as remuneration.

**(2) Appointment of secret internal inspectors**

Another step that should be examined for the purpose of preventing corruption among tax officials is the introduction of the secret internal inspector system.

Secret internal inspectors would be special staff members directly under the supervision of the Director General of the GDNT who would be in charge of identifying corruption among tax officials. These internal inspectors would secretly collect information about various types of corruption under circumstances in which their activities would be concealed. Based on these activities, the inspectors would undertake educational activities involving tax officials to prevent corruption while independently grasping the actual state of corruption as an internal organization of the GDNT. Comprehension of the actual state of corruption should be implemented through the collection of information from outside sources (it would also be necessary to institute a system for whistle-blowing), the on-site inspection of taxpayers suspicious of offering bribes and investigations into personal background and behavior.

This secret internal inspector system, which has never been instituted in Mongolia, should be promptly instituted and should function properly.

**(3) Establishment of a regular rotation system, expansion of the reward system and institution of a licensed tax accountant system**

The occurrence of corruption is partially attributable to the fact that tax officials have become accustomed to their work and the locations of their activities. Accordingly, these officials should be transferred once a year with different work locations or different kinds of activities based on the unified instructions of the GDNT. A change in the assigned work-site or work content of corrupt officials would also naturally place them under a new supervisor and working under multiple supervisors would undoubtedly make it more difficult for them to engage in corrupt activity. In this case, if work evaluation were systematized, the work evaluation file would also be transferred from the office of the former supervisor to the new supervisor. An awareness of their personal affairs could be beneficial in preventing the occurrence of corruption.

Next, substantial programs for long-service commendation awards and excellent service commendation awards should be established as a way of realizing the prevention of corruption by improving the ethical principles of tax officials. Long-service commendation awards are granted to official who has worked for a long period of time. Meanwhile, in the excellent service commendation program, in which awards are given only to excellent officials, award recipients should be chosen fairly and their achievements should be praised within the tax administration.

A certified tax accountant system would also prove to be important for the purpose of preventing corruption by tax officials. In the case of the establishment of such system, which would provide the qualifications of certified tax accountant - a suitable post-retirement occupation for tax inspectors - based on a fixed number of years of service, officials would presumably work for that number of years while persevering at a lower income level and refraining from engaging in corruption.

## **Chapter 10**





## **10 Creation of a Favorable Environment for Tax Payment**

Under the self-assessment system, it is necessary to develop the surrounding environment and improve taxpayer consciousness through tax education, public relations activities, etc. In order to create this favorable environment for tax payment, we have already submitted a proposal regarding measures for improvement of tax education and public relations activities in Phase I.

Here, we will present improvement measures for additional matters.

### **10.1 Tax Education**

- (1) In the Phase I proposal of this research mission, we pointed out that present tax education is limited to a part of tax publicity aimed at adult taxpayers, and urged that the consciousness of tax payment obligation should be planted in the minds of all the nation's people. We further proposed that if the future of Mongolia is considered, continued tax education curriculums should be devised and implemented in the course of elementary school and junior/senior high school education, and that national-level education regarding rights and obligations of taxpayers should also be provided to youths, who will be future taxpayers, as textbook-based subjects. Tax education is designed not only to teach bookkeeping techniques as a method for calculating amounts of taxes to be paid, but also to enlighten the students on what role taxes play in maintaining and developing a democratic civil society. Therefore, we additionally suggest that tax education should be given as part of subjects designed to teach the young national society matters.

The Study Team explained this to the incumbent Minister of Education in the course of the Phase II research, and the Minister of Education made such positive statements that his Ministry will introduce tax education to elementary and junior high school students. The Minister also stated that he would like to arrange consultations between the bureau directors in charge of elementary and junior high school education

and the Training Information Center of the GDNT. However, prior to the start of this education, it was learned that the following serious problems exist, so we hope that the Mongolian Government will make resolute decisions regarding the matters to be explained below.

- 1) First, if tax education is to be started, it is necessary to begin with the education of teachers, as the teachers do not have sufficient knowledge about taxes. In consideration of the present potential of the GDNT, however, it is judged fully possible for it to extend tax education to teachers.
- 2) Second, textbooks to be distributed to students must be produced, and this will cause production expenses. It is believed that there will be no problems in producing textbooks, based on consultations between the GDNT and the Ministry of Education, but under the present situation, it is difficult to say that the related budgetary burden can be borne by the GDNT or the Ministry of Education. Accordingly, we hope that the Mongolian Government will make a resolute determination, particularly regarding this budgetary issue.

At any rate, the Ministry of Education and GDNT should promptly start consultations on these problems.

- (2) Next, we suggest that the Mongolian Government take steps to achieve further upgrading of research in all tax-related fields. This will be a step directly related to the improvement of the current tax system, and it will at the same time constitute infrastructure investment indispensable for the aforementioned tax education.

Specifically, it is hoped that, for the purpose of promoting basic research related to taxes, the Mongolian Government will positively establish courses designed for taxation research in the departments of jurisprudence, public finance and accounting in principal universities, and strive to foster researchers. Furthermore, if such researchers are encouraged through some kinds of incentives to engage in research based on international exchanges, the measure will be more effective since it will

promote research not only on a tax system that matches the prevailing situation in Mongolia but also on a tax system based on an international point of view.

- (3) We also propose the establishment, within the Mongolian Government, of a lateral organization designed to promote tax research, with GDNT serving as the secretariat. (This organization is desired to hold an authoritative position, such as a council, but in the case of research on some specific matters, more flexible organizations in the form of project teams may be better.) The establishment of such an organization is expected to deepen the understanding of taxes by the related government agencies and, therefore, contribute toward the entire governmental support for the execution of tax administration. Furthermore, a variety of derivative effects can be expected. Namely, this organization may perform the function of helping the aforementioned study by university researchers from behind.

For instance, even in the case of research based on the ideas of individual researchers, if it is judged to be beneficial for the interest of the nation, the government may grant the research official recognition, which may prove helpful in these researchers' efforts to create cooperative relations with organizations inside and outside the country. It is also conceivable to appoint a suitable university researcher as a specialized study member of the organization and officially recognize his/her research activities, or to entrust a research team organized by a university with research on specific themes. Thus, a variety of support methods can be considered. (If the research team formula is adopted, and if government staff members can join the team in some form or another, it may be possible to enforce high-level training for such government members, or to make the selection of themes and research direction practical or realistic.)

## 10.2 Public Relations Activities

- (1) In order to increase the general public's interest in taxes, we would like suggest that GDNT arrange for the influence of mass communication media to enhance the taxpayer consciousness, by systematically providing suitable information to mass media. Specifically, we recommend the government amend the Law on Supervision of Tax Assessment, Payment and Tax Collection, Article 3 Clause 3, and to establish a public tax indication system under which tax collection organizations announce the names of taxpayers who made tax payment above a fixed standard, by tax items, and also the names of tax evaders.

Particularly with regard to tax evaders, the government should implement positive publicity, using mass media. Because this system is expected to enhance the taxpayer consciousness, including taxpayers, and at the same time to simulate people's reporting of tax evaders to tax officials, its prompt establishment is hoped for.

- (2) Next, new taxpayer registrants, etc., should be obligated to attend tax item-based courses during a period of one year (once for each quarter, for instance) under the Law on Supervision of Tax Assessment, Payment and Tax Collection. During the period of such courses, GDNT should give lectures and simultaneously undertake direct publicity to the attendees. Because the holding of these courses and publicity are direct actions toward new taxpayers, they are expected to effectively produce positive results.
- (3) We further propose adoption of steps to foster and organize taxpayers that have the right understanding of taxes, and to seek their cooperation in promoting the willingness to pay taxes. Because the organizing of taxpayers in reality involves many problems, it is believed unlikely to progress smoothly, so that organizing activities should be enforced vigorously, if there is any opportunity. We expect promotion of organizing activities at various levels, using all possible opportunities. Even so, the most realistic and effective step may be organizing corporate groups formed with excellent companies in Ulaanbaatar as their cores. For the issuance of invoices for VAT, relationship based on mutual trust is the premise, and if this

relationship is utilized as the axis, there seems to be a great possibility for organizing a considerable number of enterprises. Of course, if tax administration directly guide such steps, it is feared that the guidance may arouse unnecessary repulsion, based on the taxpayers' consciousness that the "encouragement of tax payment is for the convenience of the government." Therefore, it would be necessary for tax administration to entrust guidance to officially certified person who works in private sector but can consider the stance of tax administration, such as a tax accountant who formerly worked for the GDNT and is engaged in tax related activities of excellent companies.

At any rate, the existence of taxpayer groups, which are engaged in appropriate tax handling and enlighten one another for proper tax payment, represent independent tax education activities by taxpayers. It can be a substantial force that supports tax administration.

### 10.3 Other Measures

How taxpayers view the state of tax officials' work? If there is any problem, it is important to promptly and flexibly deal with it. Therefore, we propose adoption of steps to determine taxpayers' sentiment in the course of the execution of work by tax officials, and to systematically deal with such sentiment.

The reason is that the total range of activities by tax officials – from daily servicing works to on-site inspections – is itself tax-related public relations. Although executive officers are expected to understand the situation, this should be stressed repeatedly to front-line officials to ensure their thorough understanding. It is necessary to give repeated training to front-line officials so that they are “thoughtful of the view of taxpayers” in a good sense, but at the same time we would like to point out the need for executive officers to establish a method to grasp the state of on-site inspections. With regard to inspection results, we consider that an adequate setup to grasp them mathematically and for their analysis has already been established, but there appears something to be desired with regard to grasping the real situation of the inspection process. Although encouraging management for securing tax revenue for short-term periods may be necessary, executive tax officers should recognize more than ever that tax official management, based on the accurate grasping of tax officials' work, has significant meaning for the maintenance and exaltation of the taxpayers' willingness to pay taxes, eventually leading to enhance tax revenues in the long run.