

# Mining taxes

The case of Oyu Tolgoi and profitable tax avoidance by Rio Tinto in Mongolia



Mongolia



**Vincent Kiezebrink & Rhodante Ahlers & Sukhgerel Dugersuren**

January 2018

# Colophon

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Oyu Tolgoi Watch is a non-profit, non-governmental organization established in 2009 to monitor Oyu Tolgoi project's compliance with the international environmental and human rights norms and standards. OT Watch was established by a group of CSOs which have actively engaged with government and protested against signing the unfair investment agreement. Since its establishment OT Watch is working in partnership with national, international civil society networks in advocating for fair and accountable mining and investment practices respectful of human rights in the development process.



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The Centre for Research on Multinational Corporations (SOMO) is an independent, not-for-profit research and network organisation working on social, ecological and economic issues related to sustainable development. Since 1973, the organisation investigates multinational corporations and the consequences of their activities for people and the environment around the world.



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SOMO and OT Watch

Vincent Kiezebrink & Rhodante Ahlers & Sukhgerel Dugersuren

Amsterdam, January 2018

# Contents

- Executive summary ..... 3**
  
- 1 Introduction ..... 6**
  - 1.1 The importance of Oyu Tolgoi for Mongolia ..... 7
  - 1.2 Focus of the report and upcoming publications ..... 9
  - 1.3 Methodology ..... 10
  
- 2 The Oyu Tolgoi mine ..... 11**
  - 2.1 Exploration and development of Oyu Tolgoi ..... 11
  - 2.2 Oyu Tolgoi’s social and environmental impacts ..... 12
  - 2.3 Oyu Tolgoi’s ownership structure ..... 15
  - 2.4 Finance ..... 18
  
- 3 The Oyu Tolgoi Investment Agreement ..... 20**
  - 3.1 Stabilising taxes or relinquishing sovereignty? ..... 20
  - 3.2 Revenue disputes: Mongolia backs down ..... 22
  - 3.3 The Government of Mongolia’s role in Oyu Tolgoi negotiations ..... 24
  
- 4 Tax avoidance and minimisation ..... 25**
  - 4.1 Loans from Luxembourg ..... 25
  - 4.2 Tax deal in Luxembourg: avoiding Canadian taxes ..... 29
  - 4.3 Oyu Tolgoi’s abusive Investment Agreement – minimising Mongolian tax obligations ..... 32
  - 4.4 Total tax losses ..... 37
  
- 5 Treaty abuse using Dutch mailbox companies ..... 38**
  
- 6 Conclusion ..... 40**
  - 6.1 Recommendations ..... 45

## Executive summary

The Oyu Tolgoi mine, located in the Southern Gobi region, is Mongolia's flagship copper and gold mine. The mine is ultimately owned and operated by Rio Tinto, which controls it through an ownership structure consisting of multiple subsidiaries in tax havens.<sup>1</sup> The Government of Mongolia (GoM) owns a minority 34 per cent stake in the Oyu Tolgoi mine. This report reveals how Rio Tinto has managed to pressure the Mongolian Government into signing deals that are detrimental to its own interests. In this way, the company has been able to design and preserve a tax dodging scheme that has allowed it to persistently avoid substantial tax payments to Canada and Mongolia.

To finance the construction and operation of the first phase of Oyu Tolgoi, an open pit mine that produced its first mineral ore in 2013, Rio Tinto used a tax avoidance scheme involving the Netherlands and Luxembourg, two of the world's foremost tax havens.<sup>2</sup> For this scheme, over US\$ 6 billion was deposited in a mailbox company in Luxembourg. This company subsequently transferred the financing to Oyu Tolgoi, as shown in the figure below. Rio Tinto has entirely financed the construction and operation of the mine, and has provided the GoM with a loan to finance its 34 per cent ownership of the mine. This loan is subject to a London Interbank Offered Rate (LIBOR) plus 6.5 per cent, and the terms of the loan specify that it needs to be repaid in full before the GoM can receive any profits from the Oyu Tolgoi mine.

In 2013, the Mongolian Government followed advice from the IMF and cancelled its tax treaties with the Netherlands and Luxembourg, in part to tackle Rio Tinto's tax avoidance practices. At that time, a Rio Tinto spokesman explained that this move would not increase the company's tax obligations, as taxes had been "stabilised" in the Oyu Tolgoi Investment Agreement. By agreeing to stabilise – or freeze – the benefits enshrined in tax treaties at the 2009 level, the Mongolian Government effectively gave up its ability and sovereign right to determine how it taxes.

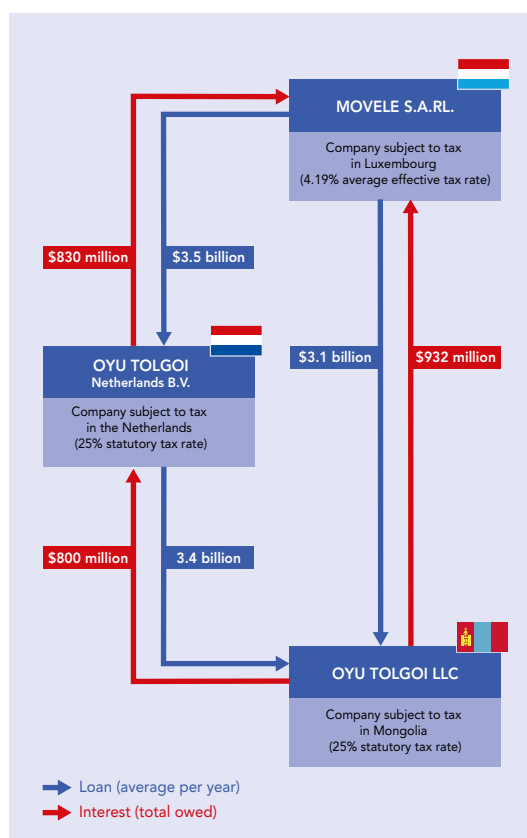
Through the tax treaty stabilisation enshrined in Oyu Tolgoi's Investment Agreement, Rio Tinto has been able to make use of the aforementioned tax treaties that were unilaterally terminated by the Mongolian Government in 2013. These (defunct) tax treaties lower the withholding tax rate applied to interest paid by Oyu Tolgoi to companies abroad from 20 per cent to 10 per cent. Rio Tinto was able to make use of these tax treaties through mailbox subsidiaries in the Netherlands and in Luxembourg. This use of mailbox companies to gain illegitimate access to tax treaty benefits is considered by the OECD as treaty abuse.<sup>3</sup>

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1 These subsidiaries are based in the Netherlands, the British Virgin Islands, Delaware, and Aruba.

2 Oxfam International, *Blacklist or whitewash? What a real EU blacklist of tax havens should look like*, 27 November 2017, <https://www.oxfam.org/en/research/blacklist-or-whitewash-what-real-eu-blacklist-tax-havens-should-look>, retrieved on 8 December 2017.

3 OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report*, 5 October 2015, <http://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report-9789264241695-en.htm>, retrieved on 8 December 2017.



The Government of Mongolia repeatedly attempted to increase its share of revenues created by Oyu Tolgoi, but without much success. In 2012, for example, it sought to secure an additional US\$ 300 million in tax revenue from the Oyu Tolgoi operation. In 2015, the GoM buckled under pressure from Rio Tinto – which at that point had fired 1700 staff and delayed its planned expansion of the mine – and accepted a fraction of the tax payments it had previously demanded.

Following the 2015 resolution of Rio Tinto’s conflict with the Government of Mongolia over the division of revenue from Oyu Tolgoi, the tax rate applied by the GoM to Rio Tinto’s interest payments going to the Netherlands and Luxembourg was lowered even further, from 10 per cent to just 6.6 per cent. This decreased tax rate was furthermore applied retroactively to Oyu Tolgoi’s past interest payments abroad, without the provision of any logical rationale for doing so. The coincidence of the conflict’s resolution and the further reduction of Rio Tinto’s tax obligation in Mongolia infers that this was a concession Rio Tinto received from

the GoM during the negotiations. As a result of the treaty shopping and the lowered tax rate, Rio Tinto managed to lower its Mongolian tax obligation by approximately US\$ 232 million. In the context of the current austerity measures being applied in Mongolia,<sup>4</sup> this income is sorely needed. For example, in recent years this amount could have allowed the Mongolian Government to nearly double its spending on education or healthcare.

The company that controls Oyu Tolgoi is Turquoise Hill Resources, a Canadian subsidiary of Rio Tinto. Leaving out fiscal considerations, this company would have been the logical choice for financing the Oyu Tolgoi operations. However, motivated by the opportunity to avoid Canadian taxes, Rio Tinto used a mailbox company with zero employees in Luxembourg to finance Oyu Tolgoi. Rio Tinto seems to have no other links to Luxembourg, a country without a significant mining industry. By making use of Movele, its Luxembourg subsidiary, Rio Tinto managed to avoid paying approximately US\$ 559 million in Canadian corporate income taxes. In Luxembourg, the company paid only US\$ 89 million in taxes on pre-tax profits of over US\$ 2.1 billion, leading to an average effective tax rate

4 Bloomberg, Mongolia Clears Hurdles Needed for \$5.5 Billion IMF-Led Bailout, 20 April 2017, <https://www.bloomberg.com/news/articles/2017-04-19/mongolia-clears-hurdles-needed-for-5-5-billion-imf-led-bailout>, retrieved 8 December 2017.

of 4.19 per cent. This tax avoidance scheme has allowed Rio Tinto to dodge a net total of US\$ 470 million in Canadian taxes.

In the six year period between 2011 and 2016, Rio Tinto thus managed to avoid paying millions of dollars in Mongolian and Canadian taxes during phase 1 of its Oyu Tolgoi operations. With the colossal expansion currently underway in phase 2 of the mine, an additional package of US\$ 4.4 billion in public finance<sup>5</sup> is involved. This raises urgent questions about the extent to which public money is flowing through tax avoidance schemes with the Oyu Tolgoi project.

Rio Tinto's success in making the Government of Mongolia accept its terms for Oyu Tolgoi has resulted in investments using interest-bearing loans and very low tax rates on the mine's profits in Luxembourg, instead of in Mongolia and Canada. This set-up leaves the Government of Mongolia empty-handed, as income is suspended during the repayment of their loans for Oyu Tolgoi.

Both the process and the content of the Investment Agreement between the corporate owners of Oyu Tolgoi and the Government of Mongolia can be characterised as deeply abusive. The repeated lowering of the withholding tax has significantly decreased any income the GoM can expect to receive from the mine, while the interest paid on the loans to Oyu Tolgoi will likely limit the mine's profitability and any dividends Mongolia can expect to earn. Consequently, it seems unlikely that the Mongolian people will substantially benefit from the Oyu Tolgoi mine.

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5 The finance for this is being provided by a group of public finance institutions, including the IFC, FMO, EBRD MIGA, Export Development Canada, the Australian Export Finance & Insurance Corp, and the US Export-Import Bank.

# 1 Introduction

*“Given the scale of Oyu Tolgoi, the creation of a safe and competitive business provides the opportunity to contribute to Mongolia’s development and the prosperity of the Mongolian people... Guided by Oyu Tolgoi’s vision, from natural wealth to enduring value, knowledge and skill, the partners and stakeholders involved with the project are firmly focused on delivering a safe and globally competitive copper business that contributes to the prosperity of Mongolia.”*

Rio Tinto<sup>6</sup>

The Oyu Tolgoi mine, located in the Southern Gobi region, is Mongolia’s flagship copper and gold mine. Not only does the site hold what is considered to be one of the world’s larger copper and gold deposits, but it is financed by the largest public finance deal in the history of the mining and metals industry.<sup>7</sup> With fully operational open pit and underground facilities, Oyu Tolgoi is projected to generate 25-30 per cent of Mongolia’s GDP by 2020.<sup>8</sup> In its first year of production in 2013,<sup>9</sup> the mine produced 77,000 tonnes of copper and almost 4,500 kg of gold; in 2016 the respective totals reached 201,300 tonnes and 8505 kg.<sup>10</sup> Based on average prices for 2016, Oyu Tolgoi production would have been valued at US\$ 979 million for copper and US\$ 342 million for gold.<sup>11</sup> All production is exported to China, the world’s largest consumer of copper and buyer of gold in 2017.<sup>12</sup> The Oyu Tolgoi mine is operated by Oyu Tolgoi LLC, which is 66 per cent owned by Turquoise Hill Resources Ltd. The other 34 per cent is owned by the state-run company Erdenes Oyu Tolgoi. Rio Tinto

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- 6 Rio Tinto website, Oyu Tolgoi, no date, <http://www.riotinto.com/copperanddiamonds/oyu-tolgoi-4025.aspx>, retrieved 27 December 2017.
  - 7 IMF, Mongolia: Joint IMF/World Bank Debt Sustainability Analysis Under the Debt Sustainability Framework for Low-Income Countries, June 2010, <https://www.imf.org/external/pubs/ft/scr/2010/cr10166.pdf>, retrieved 4 April 2017; The Guardian, Rio Tinto and Mongolia sign multibillion dollar deal on mine expansion, 19 May 2015, <https://www.theguardian.com/global/2015/may/19/rio-tinto-and-mongolia-sign-multibillion-dollar-deal-on-mine-expansion>, retrieved 4 April 2017.
  - 8 Turquoise Hill Resources, Developing the third-largest copper mine, December 2015, <http://www.turquoisehill.com/i/pdf/ppt/Scotia-Conference-Presentation2016.pdf>, retrieved 4 April 2017; <http://www.mining-technology.com/features/feature-searching-for-another-oyu-tolgoi-mongolias-big-mining-expansion-5805870/>; Extractives Industry Transparency Initiative. (2016). Overview, Mongolia. <https://eiti.org/Mongolia>, Retrieved April 4 2017.
  - 9 Rio Tinto, Annual Report 2013, [http://www.riotinto.com/annualreport2013/\\_pdfs/rio-tinto-2013-annual-report.pdf](http://www.riotinto.com/annualreport2013/_pdfs/rio-tinto-2013-annual-report.pdf) (18 July 2014).
  - 10 Rio Tinto, 2016 Annual Report: Production, reserves and operations, no date, [http://www.riotinto.com/documents/RT\\_AR2016\\_Production\\_reserves\\_operations.pdf](http://www.riotinto.com/documents/RT_AR2016_Production_reserves_operations.pdf), retrieved 27 December 2017; Turquoise Hill Resources, 2016 Annual Report, 2017, <http://www.turquoisehill.com/i/pdf/turquoise-hill-ar-FINAL.pdf>, retrieved 27 December 2017.
  - 11 The calculation of these figures is based on average annual copper and gold prices, which can be found in the sources below. Statista, Average annual market price of copper from 2009 to 2017 (in U.S. dollars per metric ton), no date, <https://www.statista.com/statistics/533292/average-price-of-copper/>, retrieved 20 January 2018; Statista, Annual average gold price from 1900 to 2017 (in U.S. dollars per troy ounce), no date, <https://www.statista.com/statistics/268027/change-in-gold-price-since-1990/>, retrieved 20 January 2018.
  - 12 Observatory of Economic Complexity, Where does Mongolia export Copper Ore to? (2016), no date, [https://atlas.media.mit.edu/en/visualize/tree\\_map/hs92/export/mng/show/2603/2016/](https://atlas.media.mit.edu/en/visualize/tree_map/hs92/export/mng/show/2603/2016/), retrieved 27 December 2017; Rio Tinto website, Oyu Tolgoi, no date, <http://www.riotinto.com/copperanddiamonds/oyu-tolgoi-4025.aspx>, retrieved 27 December 2017; Oyu Tolgoi, Exports, no date, <http://ot.mn/exports/>, retrieved 27 December 2017.



owns 51 per cent of Turquoise Hill Resources, which is a public company listed on the Toronto and New York Stock Exchanges.<sup>13</sup> The Oyu Tolgoi mine and its operator Rio Tinto play a central role in Mongolia's natural resource policies, and have inspired repeated calls for greater public control over the country's resources.

## 1.1 The importance of Oyu Tolgoi for Mongolia

The development of the Oyu Tolgoi mine has strongly influenced Mongolia's national fiscal policy, and triggered a legal reform to facilitate the signing of the 2009 Investment Agreement (IA). The IA led to discussions on natural resource politics and strengthened calls for resource nationalism in Mongolia. The second phase of the mine, involving the construction of underground facilities that include 200 kilometres of deep underground tunnels, was delayed amidst Mongolian concerns about cost overruns, tax compliance and the increased control over strategic mining assets by foreign multinationals.<sup>14</sup> Nevertheless, the Oyu Tolgoi Underground Mine Development and Financing Plan (OTUMDFP) was signed in Dubai in 2015. It was backed by the largest Multilateral Investment Guarantee Agency (MIGA) guarantee and International Finance Corporation (IFC) syndication deal ever provided by the World Bank Group.<sup>15</sup>

The global mining industry has flocked to Mongolia, with its large reservoirs of undeveloped coal, copper and gold deposits. Consequently, the country's economy leans heavily on the mining sector, which accounts for 20 per cent of its GDP, 80 per cent of total exports, 30 per cent of national budget revenue, and over 70 per cent of its foreign direct investment.<sup>16</sup> Notwithstanding its resource wealth and a 17 per cent GDP growth recorded in 2011 (since stabilised at 2 per cent),<sup>17</sup> Mongolia

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13 Orbis corporate database, ownership, Rio Tinto Plc, retrieved 4 December 2017.

14 Reuters, Mongolia must accept blame over Rio Tinto mine dispute – PM, 3 April 2015, <http://www.reuters.com/article/mongolia-oyutolgoi-idUSL3N0X01NK20150403>, retrieved 8 August 2017; Moody's, Mongolia's credit quality constrained by slowing growth and sizeable debt burden, 12 November 2015, [https://www.moody.com/research/Moodys-Mongolias-credit-quality-constrained-by-slowing-growth-and-sizeable-debt-burden--PR\\_338644](https://www.moody.com/research/Moodys-Mongolias-credit-quality-constrained-by-slowing-growth-and-sizeable-debt-burden--PR_338644), retrieved 8 August 2017.

15 World Bank, Oyu Tolgoi IFCs largest syndication deal and MIGAs largest guarantee, January 2016, at <http://www.fin4dev.org/2016/01/19/oyu-tolgoi-ifcs-largest-syndication-deal-and-migas-largest-guarantee>, The European Bank for Reconstruction and Development, EBRD arranges US 12 billion syndicated loan for Oyu Tolgoi mine, 2015, at <http://www.ebrd.com/news/2015/ebrd-arranges-us-12-billion-syndicated-loan-for-oyu-tolgoi-mine.html>, the announcements by the International Finance Corporation at [http://www.ifc.org/wps/wcm/connect/industry\\_ext\\_content/ifc\\_external\\_corporate\\_site/ogm+home/priorities/mining/oyutolgoi2c](http://www.ifc.org/wps/wcm/connect/industry_ext_content/ifc_external_corporate_site/ogm+home/priorities/mining/oyutolgoi2c), and the Multilateral Investment Guarantee Agency: <https://www.miga.org/Lists/Press%20Releases/CustomDisp.aspx?ID=506>. See also <https://www.reuters.com/article/mongolia-ebrd-loans/rpt-ebrd-says-arranges-1-2-bln-syndicated-loan-for-mongolian-mine-idUSL8N1444RU20151215>, retrieved 6 December 2016.

16 The World Bank country overview Mongolia at <http://www.worldbank.org/en/country/mongolia/overview>; See also <https://www.export.gov/article?id=Mongolia-Mining>, retrieved 4 April 2017.

17 Global finance, Countries with highest GDP Growth in 2017, October 18, 2017 at <https://www.gfmag.com/global-data/economic-data/countries-highest-gdp-growth> and International Monetary Fund country data at <http://www.imf.org/en/Countries/MNG#countrydata>, retrieved 9 December 2017. For more detail see Hatcher, P. 2016 'Le boom minier de la Mongolie et la montée du nationalisme des ressources: tensions politiques, promesses électorales et normes néolibérales' Canadian Journal of Development Studies 37(4).

### Box 1 How IMF policy requirements paved the way for Rio Tinto in Mongolia

Mongolia and its historically nomadic population have recently gone through a tremendous economic transformation. Following the disintegration of the Soviet Union and Mongolia's regained independence, the IMF, World Bank and Asian Development Bank stepped in to provide financial and policy support, bringing with them a set of Structural Adjustment Policies (SAPs). These SAPs were implemented in order to transform the centrally planned economy into one favouring the market. The 'shock therapy' applied in the 1990s reregulated the Mongolian economy in order to facilitate foreign public and private investment. The accompanying market relations and privatisation clashed with Mongolia's historically communal use of resources, resulting in what even the IMF called a "painful transformational recession". The policy reforms resulted in an institutional framework strongly conducive to foreign direct investment, and reduced public control over resources. This diminished state control attracted mining firms seeking access to Mongolia's substantive mineral wealth, and facilitated its extraction. In an upcoming publication later in 2018, SOMO will examine how the IMF's actions in Mongolia over the past decades have facilitated the legislative influence of Rio Tinto, and how this has impeded the country's ability to develop sovereign resource policies and secure public benefits from mineral extraction.

is a longstanding recipient of international aid<sup>18</sup> and relies heavily on foreign direct investment (FDI). In 2017, the country received its sixth IMF bailout loan<sup>19</sup> since 1990, thereby substantially increasing its external debt.<sup>20</sup> Mongolia's total external debt in 2017 is an estimated US\$ 26 billion, more than twice its GDP of US\$11.2 billion.<sup>21</sup> In return, Mongolia accepted a set of budget reforms that include a number of austerity measures such as a wage freeze and personal income tax increase.<sup>22</sup>

18 Since 1990, the Net ODA received per capita has fluctuated around US\$ 100 per capita. In 2016 it was US\$ 79 per capita. World Bank <https://data.worldbank.org/indicator/DY.ODA.ODAT.PC.ZS?end=2015&locations=MN&start=1976&view=chart> and OECD at [https://public.tableau.com/views/OECDDACAIadataglancebyrecipient\\_new/Recipients?:embed=y&:display\\_count=yes&:showTabs=y&:toolbar=no&:showVizHome=no](https://public.tableau.com/views/OECDDACAIadataglancebyrecipient_new/Recipients?:embed=y&:display_count=yes&:showTabs=y&:toolbar=no&:showVizHome=no), retrieved 5 december 2017.

19 International Monetary Fund, IMF Executive Board approves Financial Arrangement for Mongolia, 2017, at <https://www.imf.org/en/News/Articles/2017/05/24/17193-imf-executive-board-approves-financial-arrangement-for-mongolia>, see also Bloomberg, IMF to loan 440 million as part of 5.5 billion bailout, 2017, at <https://www.bloomberg.com/news/articles/2017-02-19/imf-to-loan-mongolia-440-million-as-part-of-5-5-billion-bailout>, retrieved 12 June 2017.

20 World Bank, International Debt Statistics 2017, pg 108 at <https://openknowledge.worldbank.org/bitstream/handle/10986/25697/9781464809941.pdf>, page 108, retrieved 4 december 2017.

21 Mongol bank, Mongolia's Gross External Debt Position at [https://www.mongolbank.mn/eng/liststatistic.aspx?id=4\\_3](https://www.mongolbank.mn/eng/liststatistic.aspx?id=4_3); Financial Times, Mongolia: living from loan to loan, September 12, 2016 at <https://www.ft.com/content/4055d944-78cd-11e6-a0c6-39e2633162d5>; FocusEconomics, <https://www.focus-economics.com/country-indicator/mongolia/external-debt>; <https://www.gfmag.com/global-data/country-data/mongolia-gdp-country-report>, retrieved August 2017.

22 Bloomberg, Mongolia clears hurdles needed for \$5.5 billion IMF bail out, 201 April 2017, at <https://www.bloomberg.com/news/articles/2017-04-19/mongolia-clears-hurdles-needed-for-5-5-billion-imf-led-bailout>, retrieved 8 august 2017.

The dependence on commodities such as copper, coal and gold has made the Mongolian economy vulnerable to volatile price fluctuations (like those occurring over the past four years),<sup>23</sup> and its government politically responsive to mining companies' demands.

Given the importance and influence of the Oyu Tolgoi mine in Mongolia, the promise by Rio Tinto cited at the start of this chapter concerning safety, sustainability and prosperity for the Mongolian people demands careful scrutiny. The case of Oyu Tolgoi – with its remarkable Investment Agreement providing Rio Tinto with a favourable fiscal position protected from legislative changes – raises questions. To what extent does the value extracted from the mine remain in Mongolia, and to what extent does the mine benefit the Mongolian people? In this report, the focus will be on these questions. In order to provide answers, the impact that the conditions for the Oyu Tolgoi investment have had on the Mongolian Government's revenue from the mine will be explored, as well as the extent to which these conditions have allowed the mine to benefit the country's people.

## 1.2 Focus of the report and upcoming publications

This report is the first in a series of three publications concerning the Oyu Tolgoi mine. This first report focuses on the fiscal planning that Rio Tinto applied with the financing of the Oyu Tolgoi mine, the tax benefits the company negotiated with the Government of Mongolia (GoM), and the subsequent revenue losses for Mongolia and Canada. The second report, to be published later in 2018, will discuss how Mongolian policy and legislations have been shaped by the influence of International Finance Institutions in enabling FDI in mining. The third and final report will deal with the public institutions involved in the financing of Oyu Tolgoi, and how this financial relationship makes these institutions responsible for the mine's adverse impacts on the people and environment of Mongolia.

This structure of the report is as follows: following this introduction, Chapter 2 describes the development, corporate structure, and financing of the Oyu Tolgoi mine. Chapter 3 provides an explanation of how the Oyu Tolgoi mine has locked the GoM into an unequal relation with Rio Tinto by discussing the Investment Agreement that governs the mine. The Investment Agreement continues to raise questions with regard to the extent that it allows revenues from the mine to flow out of Mongolia. Chapter 4 delves more into the details of tax avoidance and tax minimisation by showing how the loans financing the development of the mine run through tax havens. The chapter concludes by showing the loss in income suffered by Canada and Mongolia due to this tax avoidance scheme as well as fiscal concessions by the GoM. Rio Tinto's use of mailbox companies in the Netherlands to gain access to benefits under the country's tax and bilateral investment treaties is explained in Chapter 5.

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23 In the case of copper this is strongly (but not exclusively) influenced by China's economy as it accounts for 50% of global demand, Financial Times, Mongolia requests IMF Loan, September 30, 2016 at <https://www.ft.com/content/0bfdd635-54f6-3b11-9cbf-7b89828070a0>; On copper see Financial Times, Tailwinds building for copper after sluggish start to 2017, March 8 2017, <https://www.ft.com/content/63e2ed24-02fd-11e7-ace0-1ce02ef0def9>, and Mining.com, Copper to be best performing commodity of 2017-analysts, January 15, 2017 <http://www.mining.com/copper-best-performing-commodity-2017-analysts/>, retrieved August 2017.

The report concludes with a final chapter that provides the main findings of this research. In addition, a number of issues are identified that demand urgent attention in order for colossal projects such as the Oyu Tolgoi mine, with their detrimental ecological and social impacts, to have any lasting benefit for the people of Mongolia.

### 1.3 Methodology

The case study of Oyu Tolgoi was chosen as part of a SOMO research project on the interdependence of mining and energy development. Mongolia has previously been a topic for SOMO research on bilateral tax treaties and alternative avenues for reducing tax payments.<sup>24</sup> Various sources have been used in the research for this report, including academic literature and public finance sources, financial and mining web sources, corporate information databases like Reuters Eikon and Orbis, financial reports and annual accounts, as well as information from NGOs monitoring the developments of Oyu Tolgoi including OTWatch, OpenOil, and the CEE Bankwatch Network. Unfortunately, SOMO did not have access to the annual accounts of Erdenes Oyu Tolgoi or Oyu Tolgoi LLC. SOMO's analysis of the fiscal scheme employed for Oyu Tolgoi was reviewed by an external fiscal expert.<sup>25</sup>

As part of SOMO's internal quality assurance policies, our reports are published or shared with external parties only after the investigated company has had the opportunity to respond to research findings. On 23 December 2017, Rio Tinto was sent a copy of this report and requested to review the findings. Rio Tinto and Turquoise Hill Resources provided comments on the report, and their feedback has been incorporated where appropriate. Furthermore, their response has been published in its entirety on the SOMO website.

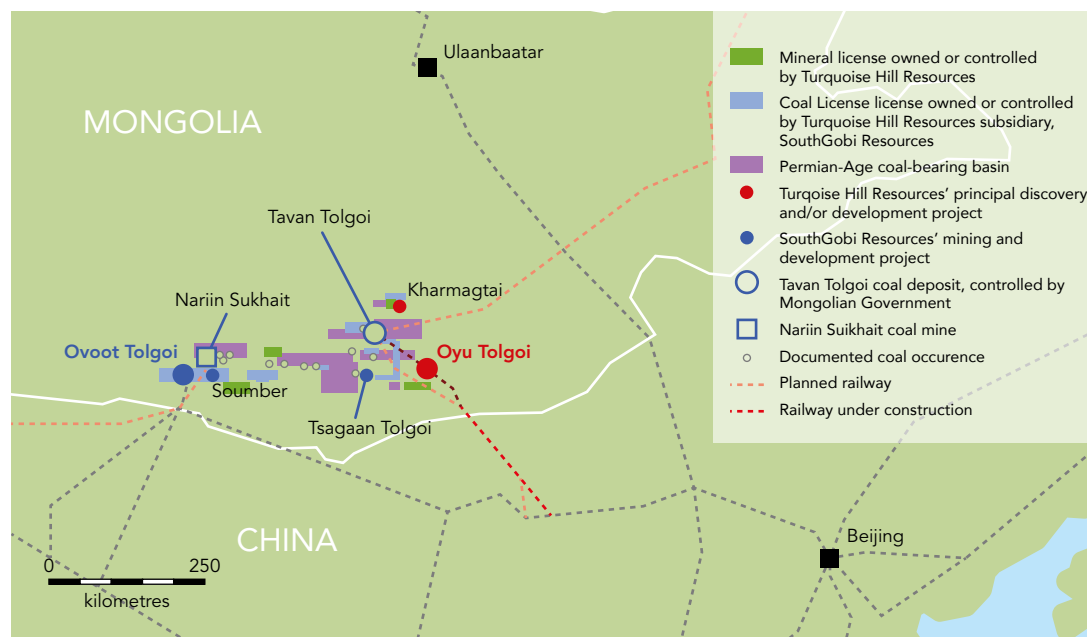
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24 SOMO, Should the Netherlands sign tax treaties with developing countries, 1 June 2013, <https://www.somo.nl/should-the-netherlands-sign-tax-treaties-with-developing-countries/>, retrieved 4 april 2017.

25 This external expert is a practicing fiscal advisor who chose not to be named in this publication.

## 2 The Oyu Tolgoi mine

Figure 1 The Oyu Tolgoi Mine in the Southern Gobi Region, Mongolia<sup>26</sup>



### 2.1 Exploration and development of Oyu Tolgoi

The Oyu Tolgoi mine is located in the Gobi Desert, 555 kilometres south of Mongolia's capital Ulaanbaatar (see Figure 1). This generally arid area is inhabited by nomadic herders, and houses a large number of endangered animal and plant species.<sup>27</sup> Mining exploration at the Oyu Tolgoi site started in the 1950s when the first signs of copper deposits were discovered. The first exploration license was acquired by BHP in 1997. In 2001, the first major gold and copper deposit was found by Ivanhoe mines and its owner Robert Friedland.<sup>28</sup> Construction of the Oyu Tolgoi open pit mine

26 Turquoise Hill Resources, Oyu Tolgoi (copper-gold), Mongolia, no date, [http://www.turquoisehill.com/s/oyu\\_tolgoi.asp?ReportID=379189](http://www.turquoisehill.com/s/oyu_tolgoi.asp?ReportID=379189), retrieved 26 January 2018.

27 M. Heiner, B. McRae, B. Lkhagvasuren, et al., Capacity building for Mongolian Ministry of Environment and Green Development (MEGDT) in relation to biodiversity and conservation in the southern Gobi Desert Mongolian Ministry of Environment and Green Development, 20 June 2016, <https://www.conservationgateway.org/ConservationByGeography/AsiaPacific/mongolia/Documents/Annex%20D.%20Connectivity%20Report%20ENG.pdf>, retrieved 5 April 2017.

28 Rio Tinto website, Oyu Tolgoi, no date, <http://www.riotinto.com/copperanddiamonds/oyu-tolgoi-4025.aspx>, retrieved 27 December 2017

started in 2011,<sup>29</sup> and its first mineral concentrates were exported to China in 2013. By 2016, the mine had produced 202,200 tonnes of copper and 18,512 kg of gold.<sup>30</sup> This open pit mine, also known as the Southern Oyu Tolgoi mine, has been in production since 2013 and constitutes the first phase of the Oyu Tolgoi mining project. The second phase of the Oyu Tolgoi project, known as Hugo North, is the underground mine that is currently under construction.<sup>31</sup> Construction of Hugo North is expected to take between five and seven years.<sup>32</sup> Our analysis in this report focuses on the first phase of the project, from 2009 until 2015. Where relevant for Oyu Tolgoi or Mongolia in general, our analysis has been supplemented by events that unfolded in 2016 and 2017. Due to the scale of the phase 1 and 2 operations, the actual and potential social and environmental impacts have been the cause of great concern.

## 2.2 Oyu Tolgoi's social and environmental impacts

The first phase of Oyu Tolgoi's development, the open pit mine, raised concerns about to what extent local communities were consulted and informed with regard to community development and the potential impacts on the social and ecological landscape. The area is sensitive to drought, and the nomadic communities living there have historically relied on common resource management rather than private property and large-scale intensive industrial development. Of particular concern were access to and quality of water, access to pasture, the diversion of the Undai River and the negative impact on water sources, the arbitrary compensation for those affected by the construction of infrastructure for the mine, the increased burden on the local hospital, and the resettlement of people.<sup>33</sup> The Environmental and Social Impact Assessments (ESIAs) were presented only after

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- 29 Mining.com. Ivanhoe Mines: Construction of Oyu Tolgoi copper-gold-silver complex advancing toward planned start of commercial production in the first half of 2013, 15 May 2011, <http://www.mining.com/ivanhoe-mines-construction-of-oyu-tolgoi-copper-gold-silver-complex-advancing-toward-planned-start-of-commercial-production-in-the-first-half-of-2013/> retrieved 4 June 2015.
- 30 Turquoise Hill Resources, Turquoise Hill announces financial results and review of operations for 2015, 17 March 2016, [http://www.turquoisehill.com/i/pdf/news/2016-03-17\\_NR.pdf](http://www.turquoisehill.com/i/pdf/news/2016-03-17_NR.pdf), retrieved 5 December 2017; Bloomberg website, Company Overview of Oyu Tolgoi LLC, no date, <https://www.bloomberg.com/research/stocks/private/snapshot.asp?privcapId=100472211>, retrieved 5 December 2017
- 31 Turquoise Hill Resources, The future of Oyu Tolgoi is Underground, June 2016, [http://www.turquoisehill.com/i/pdf/ppt/TRQ\\_Macquarie\\_Conference\\_Presentation\\_9\\_June\\_2016.pdf](http://www.turquoisehill.com/i/pdf/ppt/TRQ_Macquarie_Conference_Presentation_9_June_2016.pdf), retrieved 6 December 2017.
- 32 Oyu Tolgoi LLC, Oyu Tolgoi Underground Project, no date, [http://ot.mn/media/ot/content/operations/underground/OT\\_Underground\\_Mine\\_Poster\\_EN.pdf](http://ot.mn/media/ot/content/operations/underground/OT_Underground_Mine_Poster_EN.pdf), retrieved 6 December 2017.
- 33 IFC Compliance Advisor Ombudsman, CAO Assessment Report: Second Complaint (Oyu Tolgoi-02) Regarding the Oyu Tolgoi Project (IFC #29007 and MIGA #7041), July 2013, [http://www.cao-ombudsman.org/cases/document-links/documents/OT-2\\_Assessment\\_Report\\_ENG.pdf](http://www.cao-ombudsman.org/cases/document-links/documents/OT-2_Assessment_Report_ENG.pdf), retrieved 10 September 2017; Urgewald, Bank Information Center, OT Watch, and CEE Bankwatch, Spirited away – Mongolia's mining boom and the people that development left behind, December 2011, <http://bankwatch.org/sites/default/files/spirited-away-mongolia-mining.pdf>, retrieved 10 September 2017. European Bank for Reconstruction and Development, Oyu Tolgoi, 5 September 2012, <http://www.ebrd.com/work-with-us/projects/psd/oyu-tolgoi-.html>, retrieved 5 September 2017; Mining.com, US raises serious concerns over Oyu Tolgoi's environmental, social impact, 9 March 2013, <http://www.mining.com/us-raises-serious-concerns-over-oyu-tolgois-environmental-social-impact-21812>, retrieved 8 August 2017; The Guardian, Rio Tinto accused of environmental and human rights breaches, 18 April 2013, <https://www.theguardian.com/business/2013/apr/18/rio-tinto-environmental-human-rights-breaches>, retrieved 16 December 2017.

construction of the mine had begun, and were limited to the first phase.<sup>34</sup> In the meantime, they have been shown to be sorely inadequate.<sup>35</sup> The lack of a robust risk assessment, the failure to secure the health, safety and livelihood of the affected communities, the lack of protection for water resources and biodiversity<sup>36</sup> in the Gobi Desert, and the absence of an assessment of the cumulative impacts of the mine and its supporting infrastructure<sup>37</sup> make the assessments incomplete, if not unreliable. This is all exacerbated by weak local governance in a context where the impact of climate variability, subsequent drought, and shrinking space and mobility for herding has increased the vulnerability not only of herder livelihoods<sup>38</sup> but also that of the environment they depend upon.<sup>39</sup>

Due to International Finance Corporation (IFC) investment in the mine, herders filed two complaints with its Compliance Advisor Ombudsman in 2012, supported by OT Watch and Gobi Soil.<sup>40</sup> One complaint was related to the impact of project's land and water use on livelihoods.<sup>41</sup> The second complaint focused specifically on the Undai River diversion.<sup>42</sup> The parties, accompanied by OT Watch and Accountability Counsel, entered a dispute resolution process that ran from March 2013 until May 2017. The result was a set of agreements that include a number of actions to be undertaken related

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- 34 Letter from Oyu Tolgoi Watch to OTLLC dated 15 February 2016, , Letter from Oyu Tolgoi Watch to UKFCO dated 20 April 2012. <http://www.ebrd.com/english/pages/project/eia/41158ehsdisclsum.pdf>, retrieved 16 dec 2016.
- 35 CEE Bankwatch Network, A useless sham – Review of the Oyu Tolgoi Copper and Gold Mine Environmental and Social Impact Assessment, 14 December 2012, <https://bankwatch.org/publication/a-useless-sham-review-of-the-oyu-tolgoi-copper-and-gold-mine-environmental-and-social-impact-assessment>, retrieved on 8 August 2017; Mining.com, US raises serious concerns over Oyu Tolgoi's environmental, social impact, 9 March 2013, <http://www.mining.com/us-raises-serious-concerns-over-oyu-tolgois-environmental-social-impact-21812>, retrieved 8 August 2017.
- 36 European Bank for Reconstruction and Development, Project Number 41158, 5 September 2014, <http://www.ebrd.com/pages/project/psd/2012/41158.shtml>, retrieved on 18 July 2017.
- 37 OT Watch, Comments on the Oyu Tolgoi Environmental and Social Impact Assessment, 16 October 2012, [http://ot.mn/sites/default/files/documents/Feedback\\_ESIA\\_OT\\_Watch\\_letter.pdf](http://ot.mn/sites/default/files/documents/Feedback_ESIA_OT_Watch_letter.pdf), retrieved 18 July 2017.
- 38 Mung, Brown and Agrawal, 2013, *Global Environmental Change* 23:1673–1683; Jackson, 2015, *Geoforum* 66:94-105.
- 39 Upton (2010) *Geoforum* 41: 865–874; Sternberg and Paillou (2015) *Journal of Arid Environments* 118:21-27, The World Bank, Groundwater Assessment of the Southern Gobi Region, April 2010, <http://documents.worldbank.org/curated/en/734471468323712803/pdf/627890REPLACEMENT07018020110Box361493B.pdf>, retrieved 18 July 2014. See also for more recent details Multi Disciplinary Team and Independent Expert Panel Summary Report, January 2017, [http://www.cao-ombudsman.org/cases/document-links/documents/MDTIEP\\_FINALREPORT\\_ENG\\_January292017\\_000.pdf](http://www.cao-ombudsman.org/cases/document-links/documents/MDTIEP_FINALREPORT_ENG_January292017_000.pdf), retrieved 02 January 2018.
- 40 Both the complaint and Rio Tinto's response can be found using the following source: Business and Human Rights Resource Centre, Mongolian herders file complaint with IFC & Multilateral Insurance Guarantee Agency's accountability mechanism over Rio Tinto mine being considered for financial support, no date, <https://www.business-humanrights.org/en/mongolian-herders-file-complaint-with-ifc-multilateral-insurance-guarantee-agency%E2%80%99s-accountability-mechanism-over-rio-tinto-mine-being-considered-for-financial-support>, retrieved 8 August 2017. See also the complete CAO case documents at [http://www.cao-ombudsman.org/cases/case\\_detail.aspx?id=191](http://www.cao-ombudsman.org/cases/case_detail.aspx?id=191).
- 41 IFC Compliance Advisor Ombudsman, Complaint Regarding the Oyu Tolgoi Project (IFC #29007 and MIGA #7041), April 2013, <https://www.accountabilitycounsel.org/wp-content/uploads/2017/08/4.13-CAO-Assessment-Report.pdf>, or specifically for Phase 1 at [http://www.cao-ombudsman.org/cases/document-links/documents/OyuTolgoiCAOComplaint\\_Oct122012\\_Redacted.pdf](http://www.cao-ombudsman.org/cases/document-links/documents/OyuTolgoiCAOComplaint_Oct122012_Redacted.pdf) retrieved 8 August 2017.
- 42 IFC Compliance Advisor Ombudsman, Complaint Regarding the Oyu Tolgoi Project (IFC #29007 and MIGA #7041), April 2013, <https://www.accountabilitycounsel.org/wp-content/uploads/2017/08/7.13-CAO-Assessment-Report.pdf>, or specifically for Phase 2 at [http://www.cao-ombudsman.org/cases/document-links/documents/UndaiRiverComplaint\\_Feb32013\\_ENG.pdf](http://www.cao-ombudsman.org/cases/document-links/documents/UndaiRiverComplaint_Feb32013_ENG.pdf) retrieved 8 August 2017.

to pasture (10), water (7), monitoring (10), compensation (28), and Undai River and landscape preservation (30). In addition, the agreement included a sustainable livelihood programme composed of ten projects, and the identification of eight locations to be rehabilitated and restored by Oyu Tolgoi.<sup>43</sup>

The second phase of Oyu Tolgoi will be developed underground, where 80 per cent of the mine's value is purportedly located. The operation is described in the Oyu Tolgoi Underground Mine Development and Financing Plan (OTUMDFP 2015). Production is planned to start in 2019, and the combined production from open pit and underground would amount to more than 500,000 tonnes of ore annually.<sup>44</sup> To access the underground ore, the block caving mining method will be used, reaching up to 1300 metres below ground and involving 200 kilometres of tunnels and 10 kilometres of conveyer belt. The scale of the operation and the use of block cave mining carry the danger of subsidence, and the surface above the extraction zone is likely to remain permanently unstable. The impact of block cave mining is still little understood, and it is argued that significantly more detailed impact calculations are required.<sup>45</sup>

Rio Tinto employs a cave tracker device to reduce waste and improve profitability, and hope that this will make cave mining safer.<sup>46</sup> Nevertheless, experience has shown that the "[C]hanges to surface landforms brought about by subsidence can be dramatic and may lead to a pronounced environmental impact".<sup>47</sup> The 2015 OTUMDFP and the 2014 Oyu Tolgoi Technical Report have been criticised<sup>48</sup> for not including plans for either a supplemental or new ESIA covering the project's second underground phase. Nevertheless, even the quantitative assessment provided by the 2012 ESIA shows the impact to be significant and describes that the subsidence zone is expected to cover at least an area of 8km<sup>2</sup> that not only provide safety risks but also affect hydrogeology and geology.<sup>49</sup>

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- 43 Accountability Counsel, Mongolian Herders Secure Historic Agreement with Oyu Tolgoi Mine, Government to Protect Herds, Health and Livelihoods, no date, <https://www.accountabilitycounsel.org/blog-post/mongolian-herders-secure-historic-agreement-with-oyu-tolgoi-mine-government-to-protect-herds-health-and-livelihoods/>, retrieved 8 August 2017.
- 44 Turquoise Hill Resources, Oyu Tolgoi: Advancing value, creating options, December 2017, <http://www.turquoisehill.com/i/pdf/ppt/Presentation-Dec-06-2017.pdf>, retrieved 2 January 2018.
- 45 Woo, K-S et al (2013) Empirical investigation and characterization of surface subsidence related to block cave mining, *International Journal of Rock Mechanics & Mining Sciences* (61)13: 31–42; Vyazmensky, A. (2008) Numerical modelling of surface subsidence associated with block cave mining using a finite element/discrete element approach. Thesis submitted in partial fulfilment of the requirements for the degree of doctor of philosophy in the earth sciences, Simon Fraser University.
- 46 Rio Tinto website, The holy grail of caving, 1 June 2016, [http://www.riotinto.com/ourcommitment/spotlight-18130\\_18228.aspx](http://www.riotinto.com/ourcommitment/spotlight-18130_18228.aspx), retrieved 4 April 2017.
- 47 Mining Magazine, Keeping up with caving, June 2012, [http://www.redpathmining.com/wp-content/uploads/2012/07/Block-Caving\\_Mining-Magazine-June-2012.pdf](http://www.redpathmining.com/wp-content/uploads/2012/07/Block-Caving_Mining-Magazine-June-2012.pdf), retrieved 4 April 2017.
- 48 CEE Bankwatch Network, Oyu Tolgoi Phase 2: Plans, Issues and Risks, 11 February 2016, <https://bankwatch.org/publication/oyu-tolgoi-phase-2-plans-issues-and-risks>, retrieved 4 April 2017.
- 49 ESIA Oyu Tolgoi Project ,2012, Section C Impact Assessment, Chapter 4, Topography, Landscape, Geology and Topsoils, pg 10 at [http://ot.mn/media/ot/content/page\\_content/commitments/ESIA/1\\_ESIA/Impact\\_Assessment/ESIA\\_OT\\_C4\\_Topography\\_EN.pdf](http://ot.mn/media/ot/content/page_content/commitments/ESIA/1_ESIA/Impact_Assessment/ESIA_OT_C4_Topography_EN.pdf)), retrieved 02 January 2018.



## 2.3 Oyu Tolgoi's ownership structure

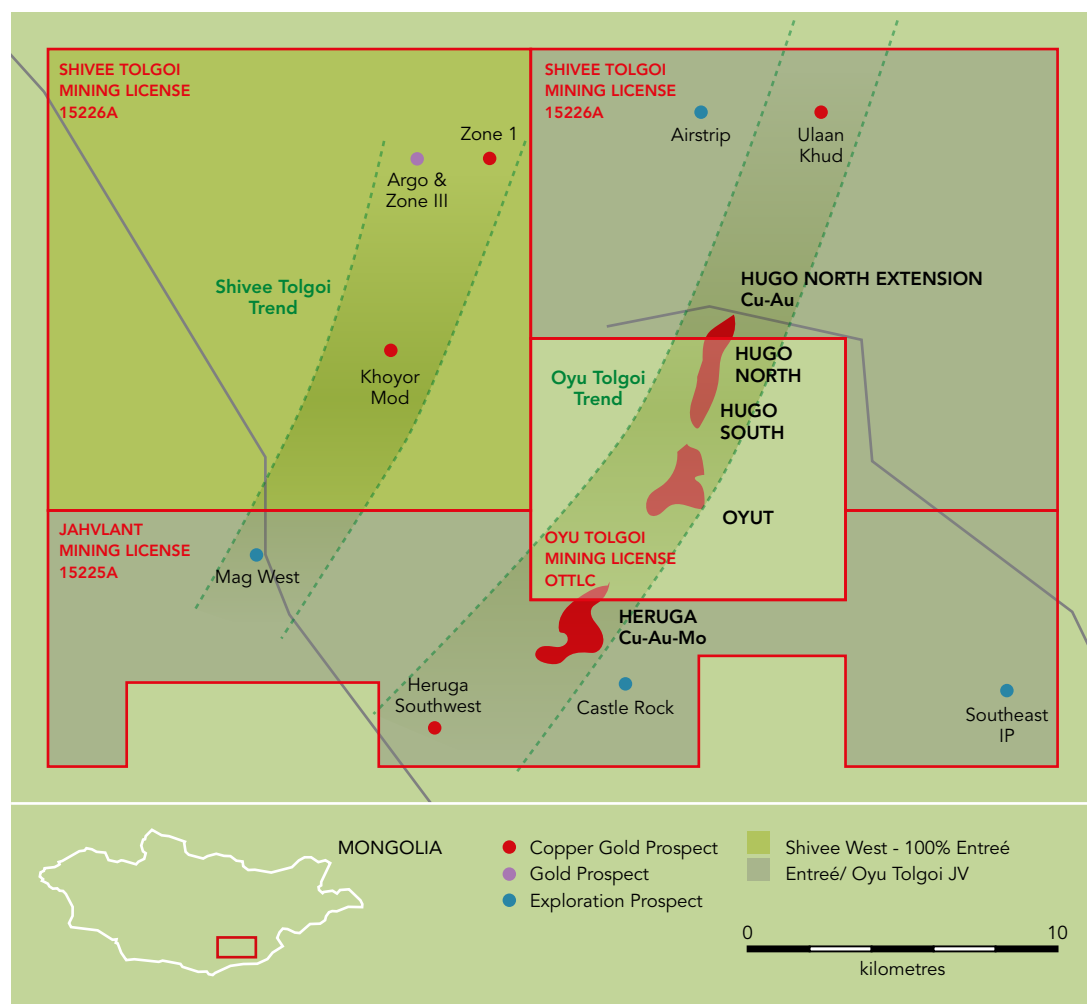
The Oyu Tolgoi mineral deposit was originally owned by Canadian mining company Ivanhoe Mines, until Rio Tinto attained a majority stake in Ivanhoe in 2012.<sup>50</sup> Subsequently, Ivanhoe Mines changed its name to Turquoise Hill Resources<sup>51</sup> – the English translation of Oyu Tolgoi – in which Rio Tinto now has a 51 per cent stake.<sup>52</sup> Turquoise Hill Resources is registered in Canada, while the remaining 49 per cent of its shares are listed on the New York Stock Exchange.

Both the Oyu Tolgoi open pit mine (phase 1) and the underground mine (phase 2) are directly owned by a Mongolian company called Oyu Tolgoi LLC. Oyu Tolgoi LLC owns 66 per cent of the Oyu Tolgoi mine, while the state-owned Erdenes Oyu Tolgoi company owns the remaining 34 per cent.<sup>53</sup> This percentage of state ownership is prescribed in the Mongolian Minerals Law of 2006, which allows the government to claim up to 50 per cent of any mining enterprise within its jurisdiction.<sup>54</sup> Oyu Tolgoi LLC's ultimate parent company is Turquoise Hill Resources, which is majority controlled by Rio Tinto. The actual operator of the Oyu Tolgoi mine is Rio Tinto, meaning that besides its ultimate ownership of the mine, the company also directly controls it.

Apart from the Oyu Tolgoi mine itself, Oyu Tolgoi LLC – and thus ultimately Rio Tinto as its majority shareholder – also has a stake in mining licenses for several other nearby mineral deposits. Through a joint venture with the Canadian gold mining company Entrée Resources, Oyu Tolgoi LLC has a stake in the exploitation of the eastern part of the Shivee Tolgoi<sup>55</sup> as well as the Javhlant mineral deposits.<sup>56</sup> The joint venture, entitled Entrée/Oyu Tolgoi JV Property, is 80 per cent owned by Oyu Tolgoi LLC, while the remaining 20 per cent is held by Entrée Resources. Furthermore, Rio Tinto and Turquoise Hill Resources Ltd. are shareholders of Entrée Resources Ltd, holding respectively 10 per cent and 8 per cent (see Figure 2).<sup>57</sup>

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- 50 Financial Post, Rio Tinto takes majority stake in Ivanhoe, 24 January 2012, <http://business.financialpost.com/investing/rio-tinto-takes-majority-stake-in-ivanhoe>, retrieved 8 August 2017; Financial Times, Ivanhoe chief departs as Rio tightens grip, 18 April 2012, <https://www.ft.com/content/970e22c6-8973-11e1-85b6-00144feab49a>, retrieved 8 August 2017.
- 51 Market Wired, Ivanhoe Mines Changes Name to Turquoise Hill Resources, 2 August 2012, <http://www.marketwired.com/press-release/ivanhoe-mines-changes-name-to-turquoise-hill-resources-tsx-ivn-1686881.htm>, retrieved 8 August 2017.
- 52 Reuters Eikon database, Turquoise Hill Resources, Shareholders report, retrieved 6 December 2017.
- 53 Oyu Tolgoi website, Oyu Tolgoi Shareholders, no date, <http://ot.mn/oyu-tolgoi-shareholders/>, retrieved 6 December 2017.
- 54 US Department of State, 2013 Investment Climate Statement – Mongolia, April 2013, <https://www.state.gov/e/eb/rls/othr/ics/2013/204697.htm>, retrieved 8 August 2017.
- 55 The western part of the deposit belongs exclusively to Entrée Resources. Entrée Resources, map of the Oyu Tolgoi area, January 2018, [http://www.entreeresourcesltd.com/\\_resources/projects/overview/Lookout-Hill-July2017\\_WEB.jpg](http://www.entreeresourcesltd.com/_resources/projects/overview/Lookout-Hill-July2017_WEB.jpg), retrieved 8 August 2017.
- 56 Entrée Resource website, Overview, no date, <http://www.entreeresourcesltd.com/projects/entree-oyu-tolgoi-joint-venture/overview/>, retrieved 8 August 2017.
- 57 Entree Resources website, About Us, no date, <http://www.entreeresourcesltd.com/>, retrieved 8 August 2017.

Figure 2 Oyu Tolgoi LLC and Entrée Resources’ individual and joint mining license areas<sup>58</sup>



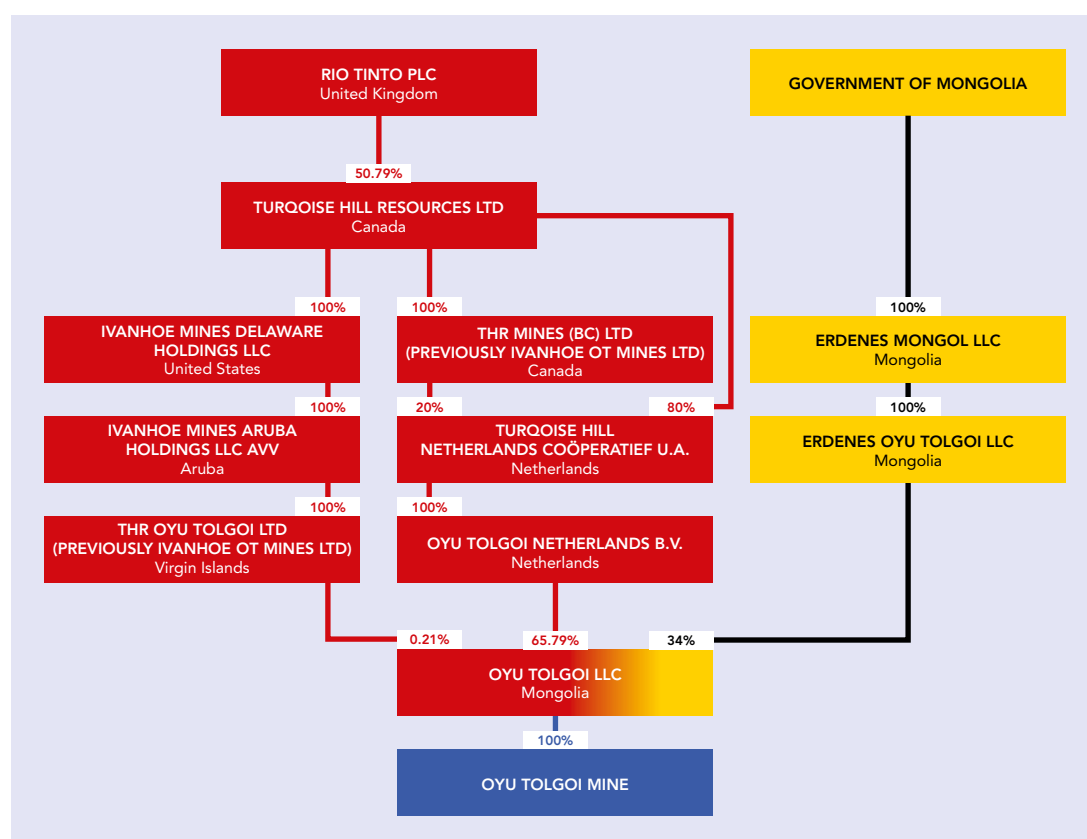
Along with Rio Tinto, the other major corporate shareholders of Turquoise Hill Resources – thus also beneficial owners of the Oyu Tolgoi mine – are SailingStone Capital Partners (US\$ 754 million worth of shares), Pentwater Capital Management (US\$ 298 million), Temasek Holdings (US\$ 227 million), Capital Growth Management (US\$ 118 million), the Vanguard Group (US\$ 74 million), and Anchor Bolt Capital (US\$ 68 million).<sup>59</sup> All of these companies are investment managers, with the exception of Temasek Holdings which is the Singaporean state-owned company that manages the country’s sovereign wealth fund.<sup>60</sup>

58 Entrée Resources, map of the Oyu Tolgoi area, January 2018, [http://www.entree-resources.com/\\_resources/projects/overview/Lookout-Hill-July2017\\_WEB.jpg](http://www.entree-resources.com/_resources/projects/overview/Lookout-Hill-July2017_WEB.jpg), retrieved 8 August 2017.

59 Reuters Eikon, Turquoise Hill Resources, Shareholders report, retrieved 8 August 2017.

Ten pension funds also hold stakes in Oyu Tolgoi, the most notable ones being CPP Investment Board (US\$ 24.9 million's worth of shares), PSP Investments (US\$ 16.9 million), British Columbia Investment Management Corporation (US\$ 16 million), and the Florida State Board of Administration (US\$ 10 million).<sup>61</sup> Two of the Netherlands' largest pension funds – PGGM and APG – also own Turquoise Hill Resources shares, valued respectively at US\$ 1.8 million and US\$ 598,000.<sup>62</sup> Turquoise Hill Resources owns other mining operations in addition to Oyu Tolgoi, and the company's ownership structure detailing its subsidiaries is quite extensive. Figure 3 below shows the ownership of all of the subsidiaries found during this research to be involved in the Oyu Tolgoi mine:

**Figure 3 Ownership structure of Oyu Tolgoi<sup>63</sup>**



60 Bloomberg, Company Overview of Temasek Holdings (Private) Limited, no date, <https://www.bloomberg.com/research/stocks/private/snapshot.asp?privcapId=107637>, retrieved 8 August 2017.

61 Reuters Eikon, Turquoise Hill Resources, Shareholders report, retrieved 8 August 2017.

62 Reuters Eikon, Turquoise Hill Resources, Shareholders report, retrieved 8 August 2017.

63 Orbis, Rio Tinto Plc, Ownership report, retrieved 4 December 2017; Oyu Tolgoi, Our Company, <http://ot.mn/our-company-en/?eoi>, no date, retrieved 4 December 2017.

The right side of the figure above shows that Oyu Tolgoi LLC, the direct owner of the Oyu Tolgoi mine, is minority owned by the Government of Mongolia (GoM), which holds a 34 per cent share through two of its subsidiaries. To the left, the figure shows that Turquoise Hill Resources, and Rio Tinto by extension, control the majority share of Oyu Tolgoi LLC. The company is owned through two chains of subsidiaries: the first chain is made up of two Dutch subsidiaries, and the other is a Canadian subsidiary owned by the parent company Turquoise Hill Resources. On the far left side you find that there is a 0.21 per cent stake in Oyu Tolgoi LLC held by a company registered on the British Virgin Islands. This company is called THR Oyu Tolgoi, and it is fully owned by a company in Aruba, which is in turn owned by a company in Delaware, leading back to Turquoise Hill Resources itself. The British Virgin Islands (BVI), Aruba and Delaware are all known tax havens.<sup>64</sup>

Although THR Oyu Tolgoi's level of involvement in the Oyu Tolgoi mine is unclear, the fact that it is registered in the BVI – a jurisdiction known for tax avoidance rather than for its mining industry – indicates that this company was set up for fiscal purposes in relation to the mine. In their response to this report, Turquoise Hill Resources and Rio Tinto wrote that THR Oyu Tolgoi is a legacy of the funding structure that was used before 2009, and that since then it has not been used to finance any activities in Mongolia. Its current role, however, remains unclear due to a lack of financial transparency in the BVI. This, as well as the role played by the Dutch subsidiaries in tax avoidance with respect to the Oyu Tolgoi mine, will be discussed in detail in Chapter 4.

## 2.4 Finance

Turquoise Hill Resources owns approximately 66 per cent of Oyu Tolgoi LLC, which controls the license to exploit the Oyu Tolgoi mine. The remaining 34 per cent is owned by Erdenes Oyu Tolgoi, the Mongolian state-owned company. The aggregate cost for both the first phase (the open pit mine and associated infrastructure) and the second phase (the underground mine for the Hugo North deposits) have been estimated at around US\$ 12 billion.<sup>65</sup>

To finance the construction and operation of the first phase of the Oyu Tolgoi mine, the owners were required to provide between US\$ 6.6<sup>66</sup> and US\$ 7.8<sup>67</sup> billion in capital. Because Erdenes Oyu Tolgoi did not have access to the funds required to finance its 34 per cent of the mine's costs, the company was required to borrow its share from Turquoise Hill Resources. A London Interbank Offered Rate

64 Financial Secrecy Index, Financial Secrecy Index 2015, 2015, <http://www.financialsecrecyindex.com/>, retrieved 8 August 2017.

65 International Finance Corporation, Project number 29007, 28 February 2013, <http://ifcext.ifc.org/ifcext/spiwebsite1.nsf/ProjectDisplay/SII29007>, retrieved 18 July 2014.

66 Oyu Tolgoi LLC, "Official statement of Oyu Tolgoi LLC in relation to information, data and facts related to Oyu Tolgoi discussed during open session of the State Great Khural dated 1 February, 2013," 5 February 2013, <http://www.mongoliaeconomy.com/official-statement-of-oyu-tolgoi-llc-in-relation-to-information-data-and-facts-related-to-oyu-tolgoi-discussed-during-open-session-of-the-state-great-khural-dated-1-february-2013>, retrieved 12 December 2016.

67 Market Wired, Turquoise Hill Announces Financial Results and Review of Operations for 2014, 24 March 2015, <http://www.marketwired.com/press-release/turquoise-hill-announces-financial-results-and-review-of-operations-for-2014-nyse-trq-2003339.htm>, retrieved 14 July 2015.

(LIBOR) rate plus 6.5 per cent interest was set for the loan.<sup>68</sup> Given the possibility that Erdenes may not be able to pay back these loans and to ensure that Turquoise Hill Resources is compensated, the shareholders' agreement states that any dividends from Oyu Tolgoi LLC to Erdenes Oyu Tolgoi will be paid to Turquoise Hill Resources until the loans are fully repaid.<sup>69</sup> Considering the formidable loans used to fund the project and the accruing interest on these loans, the dividends that Mongolia will receive from Oyu Tolgoi will likely be limited. In 2015, a report by the civil society organisation OpenOil concluded that it would likely be many years before the Mongolian state would receive revenue from its shares in the Oyu Tolgo mine.<sup>70</sup> On 1 June 2017, roughly four years after Oyu Tolgoi started production, the balance of outstanding loan payments showed that the GoM still owes US\$ 1.1 billion to Turquoise Hill Resources.<sup>71</sup> Although neither the Mongolian state nor Oyu Tolgoi's other shareholders have as of yet received dividends, Rio Tinto is making a profit on the loan it has provided to Oyu Tolgoi. This profit will be further elaborated on later in the report.

The mining industry is known for the intricate schemes it uses to avoid paying taxes.<sup>72</sup> Mining companies have access to an array of dubious measures that allow them to lower their tax bills in the countries where they operate. These include transfer mispricing of management fees and mineral trades,<sup>73</sup> as well as so-called cross-currency interest rate swaps.<sup>74</sup> Generally, such actions increase costs and lower profits at the operational level – for Oyu Tolgoi LLC in this case – while increasing profits in low-tax jurisdictions. At the moment, Rio Tinto is disputing a US\$ 360 million tax bill from the Australian Government, which alleges that the company has used transfer mispricing to shift profits to a subsidiary in low-tax Singapore in order to avoid Australian taxes.<sup>75</sup> Because Oyu Tolgoi LLC is not required to publish its annual accounts, it was impossible to look into the company's financial management to investigate whether Rio Tinto currently employs any such measures.

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- 68 Erdenes Mongolia LLC, Ivanhoe Oyu Tolgoi (BVI) Ltd, Oyu Tolgoi Netherlands BV, and Oyu Tolgoi LLC, Amended and Restated Shareholders Agreement, article 11.3e, 8 June 2011, <http://www.turquoisehill.com/i/pdf/OT-ARSHA-ENG-2011-06-08-Executed.pdf>, retrieved 8 September 2017; Oyu Tolgoi Netherlands BV, annual reports for 2013, 2014, and 2015. These reports can be retrieved from the Dutch Chamber of Commerce: <https://www.kvk.nl/zoeken/> (website in Dutch).
- 69 Erdenes Mongolia LLC, Ivanhoe Oyu Tolgoi (BVI) Ltd, Oyu Tolgoi Netherlands BV, and Oyu Tolgoi LLC, Amended and Restated Shareholders Agreement, article 15.2b, 8 June 2011, <http://www.turquoisehill.com/i/pdf/OT-ARSHA-ENG-2011-06-08-Executed.pdf>, retrieved 8 September 2017.
- 70 Open Oil, Oyu Tolgoi Financial Model: Narrative Report, September 2016, <http://openoil.net/wp/wp-content/uploads/2016/10/Oyu-Tolgoi-Project-Fiscal-Model-Narrative-Report.pdf>, retrieved on 20 November 2017.
- 71 Turquoise Hill Resources, Oyu Tolgoi: Advancing value, creating options, August 2017, <http://www.turquoisehill.com/i/pdf/ppt/Presentation-Aug-2017-FINAL.pdf>, retrieved 2 January 2018.
- 72 Natural Resource Governance Institute, Preventing Tax Base Erosion in Africa: a Regional Study of Transfer Pricing Challenges in the Mining Sector, July 2016, [https://resourcegovernance.org/sites/default/files/documents/nrgi\\_transfer-pricing-study.pdf](https://resourcegovernance.org/sites/default/files/documents/nrgi_transfer-pricing-study.pdf), retrieved 2 January 2018.
- 73 Publish What You Pay, Many ways to lose a billion, June 2017, <http://www.publishwhatyoupay.org/wp-content/uploads/2017/07/PWYP-Report-ManyWaysToLoseABillion-EN-INTERACTIVE.pdf>, retrieved 2 January 2018.
- 74 ABC News, The tax trick big miners use to avoid paying millions, 6 November 2017, <http://www.abc.net.au/news/2017-11-06/ato-investigating-multinationals-amid-paradise-papers-leak/9075642>, retrieved 2 January 2018; Australian Taxation Office, Arrangements involving related party foreign currency denominated finance with related party cross currency interest rate swaps, 26 April 2016, <http://law.ato.gov.au/atolaw/view.htm?docid=%22TPA%2FTA20163%2FNAT%2FATO%2F00001%22>, retrieved 2 January 2018.
- 75 Financial Times, Rio Tinto to fight \$360m Australian tax bill, 5 April 2017, <https://www.ft.com/content/676d74c0-1a11-11e7-bcac-6d03d067f81f>, retrieved 10 December 2017.

## 3 The Oyu Tolgoi Investment Agreement

After five years of negotiations, the Oyu Tolgoi Investment Agreement was signed by Ivanhoe Mines, Rio Tinto and the Government of Mongolia in October 2009. This agreement establishes the conditions and assurances governing Turquoise Hill Resources' investment in the Oyu Tolgoi mine, including the rules governing investments in infrastructure, environmental requirements, labour relations, investment protection against expropriation, and the taxation environment affecting the investment.<sup>76</sup> The content of the Investment Agreement remained controversial, raising questions about the agreed-upon share of wealth that would remain in Mongolia. In 2013, the Mongolian Government sought to amend the agreement, which led to a delay in the financing and construction of the second underground phase of the mine.

### 3.1 Stabilising taxes or relinquishing sovereignty?

Chapter 2 of the Investment Agreement is called "Taxation Environment", and describes how Oyu Tolgoi's production and profits should be taxed. Its first article states that a number of the tax types that Oyu Tolgoi's operations are subject to are stabilised at 2009 levels, as specified in Mongolia's General Taxation Law. These include income taxes, value-added taxes, royalties and other taxes. The taxation chapter also states that withholding taxes owed by Turquoise Hill Resources and its subsidiaries are also stabilised at 2009 levels. Withholding taxes are taxes levied on dividend, royalty, and interest payments made by companies inside Mongolia to companies outside the country. For example, if Oyu Tolgoi LLC pays dividends to its parent company Oyu Tolgoi Netherlands BV, a percentage of this payment is owed to the Mongolian Government as withholding tax.

Following Mongolian law, the company applies 20 per cent withholding tax rates to dividend, royalty and interest payments made abroad.<sup>77</sup> However, Double Taxation Agreements (DTAs) with other countries include clauses that lower these withholding taxes on payments made between states that are parties to these agreements. For example, interest payments made from Mongolia to Malaysia are not subject to a 20 percent withholding tax rate, but rather to a maximum of 10 per cent as determined in the DTA between these countries.<sup>78</sup> With respect to withholding taxes, the Investment Agreement between the Mongolian Government and Turquoise Hill Resources stabilised not only the tax rates as enshrined in domestic law, but also the lower rates contained in Mongolia's DTAs at that time.

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76 The Government of Mongolia, Ivanhoe Mines Mongolia Inc LLC, Ivanhoe Mines Ltd, and Rio Tinto International Holdings Limited, Investment Agreement, 6 October 2009, [http://www.turquoisehill.com/i/pdf/Oyu\\_Tolgoi\\_IA\\_ENG.PDF](http://www.turquoisehill.com/i/pdf/Oyu_Tolgoi_IA_ENG.PDF), retrieved 8 August 2017.

77 PricewaterhouseCoopers, Mongolia: Corporate - Withholding taxes, no date <http://taxsummaries.pwc.com/ID/Mongolia-Corporate-Withholding-taxes> retrieved 8 August 2017.

78 PricewaterhouseCoopers, Mongolia: Corporate - Withholding taxes, no date <http://taxsummaries.pwc.com/ID/Mongolia-Corporate-Withholding-taxes> retrieved 8 August 2017.

In 2012, the International Monetary Fund (IMF) published a report detailing how Mongolia's DTAs with several other countries allowed companies to avoid paying taxes in Mongolia. The report identified four DTAs that limit Mongolia's ability to safeguard its tax revenues: the agreements with Kuwait, Luxembourg, the United Arab Emirates, and the Netherlands.<sup>79</sup> Among other issues, the report explained how the DTA between the Netherlands and Mongolia lowered withholding taxes on dividends to 0 per cent under specific circumstances. These circumstances likely applied to the dividends paid to Oyu Tolgoi Netherlands BV for the Oyu Tolgoi mine. These findings explain earlier statements by Robert Friedland, the former chair of Turquoise Hill Resources (then called Ivanhoe Mines). In 2011, Mr Friedland proclaimed that Turquoise Hill Resources was anticipating very low tax rates with regard to its future Mongolian operations. According to him, the company had good relations with the Mongolian Government, including its President, and was expecting to pay virtually zero tax on dividends remitted from Mongolia to Canada.<sup>80</sup> Considering that only the Mongolian DTAs with the Netherlands and the United Arab Emirates provided a flat 0 per cent rate<sup>81</sup> and that the ownership of Oyu Tolgoi is now held by Oyu Tolgoi Netherlands BV, it seems likely that Mr Friedland was referring to the use of the Dutch-Mongolian DTA to substantially lower its tax obligations in Mongolia.

Following publication of the IMF report, the Mongolian Government announced that it would unilaterally terminate these four agreements.<sup>82</sup> By reclaiming the right to tax financial flows leaving its jurisdiction, Mongolia attempted to regain control over its tax revenue. The DTA with the Netherlands was officially annulled on 1 January 2014.<sup>83</sup> However, in an interview with Reuters, a Rio Tinto spokesperson stated that the cancellation of the DTA with the Netherlands would not affect the withholding taxes paid with regard to the Oyu Tolgoi mine.<sup>84</sup> As the Oyu Tolgoi Investment Agreement includes the stabilisation of withholding tax rates at 2009 levels, Turquoise Hill and Rio Tinto were unaffected by Mongolia's action. To be clear, the four DTAs cancelled by the Mongolian Government remain defunct. Based on the Investment Agreement, only Oyu Tolgoi's investors can currently make use of the benefits formerly enshrined within them, and these benefits will likely only affect the extent to which Mongolia is allowed to levy taxes on Oyu Tolgoi and its investors, and not the extent to which its former treaty partners can levy taxes. The detrimental impact this arrangement has had on Mongolia's tax revenue from the Oyu Tolgoi mine will be explored further in Chapter 4.

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- 79 IMF, *Mongolia: Technical Assistance Report – Safeguarding Domestic Revenue – A Mongolian DTA Model*, November 2012, <https://www.imf.org/external/pubs/ft/scr/2012/cr12306.pdf>, retrieved 8 November 2017.
- 80 MiningWatch Canada, *Mining Mongolia: Ivanhoe, T-shirts, NGOs, and Wikileaks*, 5 June 2011, <https://miningwatch.ca/blog/2011/6/5/mining-mongolia-ivanhoe-t-shirts-ngos-and-wikileaks>, retrieved 15 December 2017.
- 81 IMF, *Mongolia: Technical Assistance Report – Safeguarding Domestic Revenue – A Mongolian DTA Model*, November 2012, <https://www.imf.org/external/pubs/ft/scr/2012/cr12306.pdf>, retrieved 8 November 2017.
- 82 Business Council of Mongolia, *Mongolia cancels double-tax contracts*, 20 February 2013, <http://mail.bcmongolia.org/en/mongolia-business-news/174-mongolia-cancels-double-tax-contracts>, retrieved 10 September 2017.
- 83 KPMG, *Mongolia Tax Profile*, July 2016, <https://home.kpmg.com/content/dam/kpmg/xx/pdf/2016/09/country-tax-profile-mongolia.pdf>, retrieved 16 August 2017.
- 84 Reuters, *Special report: In tax case, Mongolian is the mouse that roared*, 16 July 2013, <https://www.reuters.com/article/us-dutch-mongolia-tax/special-report-in-tax-case-mongolia-is-the-mouse-that-roared-idUSBRE96F0B620130716>, retrieved 16 August 2017.

## 3.2 Revenue disputes: Mongolia backs down

One of the main issues of contention between the Mongolian government and Rio Tinto surfaced in 2006, two years into the negotiations. At that time, Mongolia had introduced a new windfall profit tax for mining companies that would allow the state to levy additional tax on the production of copper and gold when market prices for these commodities reached a certain threshold. In response, with stock markets anticipating the taxes that would have to be paid by Oyu Tolgoi LLC, share prices for Turquoise Hill Resources (then still Ivanhoe Mines) dropped by 21 per cent.<sup>85</sup> In the following years, Rio Tinto and Turquoise Hill Resources reportedly lobbied the government to drop this windfall tax, and even demanded it as a condition for their investment in Oyu Tolgoi. In 2009, Mongolia gave in to their demands, and in 2011 the windfall profits tax was formally rescinded.<sup>86</sup>

In 2011, the GoM considered increasing its ownership in Oyu Tolgoi by amending the Investment Agreement. Citing the large profits the mine was making at the time, several lawmakers urged the government to raise its stake in the mine to 40 per cent.<sup>87</sup> Investors reportedly rejected the idea, stating these were ill-conceived populist policies that could hamper Mongolia's mining boom.<sup>88</sup> Nevertheless, in 2012 the GoM announced that it was seeking to renegotiate Oyu Tolgoi's Investment Agreement in order to increase tax revenue from the mine by US\$ 300 million.<sup>89</sup> In a general attempt to increase the nation's share of mining profits, Mongolia tried to pass a US\$ 340 million tax bill onto mining companies, driven by the same call for greater public control over resources advanced in 2006. The GoM was also concerned about the rising costs of the mine and the deepening debt that the government would bear with its expansion.<sup>90</sup> Moreover, when the Great Khural, Mongolia's unicameral parliament, audited Oyu Tolgoi in 2013 it found numerous cost overruns connected with excessive management service fees.<sup>91</sup>

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85 CBC News, Ivanhoe 'surprised' by new Mongolian windfall tax, 15 May 2006, <http://www.cbc.ca/news/business/ivanhoe-surprised-by-new-mongolian-windfall-tax-1.622422>, retrieved 18 August 2017.

86 US Department of State, 2013 Investment Climate Statement – Mongolia, April 2013, <https://www.state.gov/e/eb/rls/othr/ics/2013/204697.htm>, retrieved 8 August 2017.

87 Reuters, Mongolia discussing changes to Oyu Tolgoi copper deal –report, 20 September 2011, <https://www.reuters.com/article/mongolia-oyutolgoi/mongolia-discussing-changes-to-oyu-tolgoi-copper-deal-report-idUSL3E7KK1TO20110920>, retrieved 16 August 2017.

88 Reuters, Mongolia discussing changes to Oyu Tolgoi copper deal –report, 20 September 2011, <https://www.reuters.com/article/mongolia-oyutolgoi/mongolia-discussing-changes-to-oyu-tolgoi-copper-deal-report-idUSL3E7KK1TO20110920>, retrieved 16 August 2017.

89 The New York Times, Tax Proposal in Mongolia Threatens Rio Tinto Project, 15 October 2012, <https://dealbook.nytimes.com/2012/10/15/tax-proposal-in-mongolia-threatens-rio-tinto-project/>, retrieved 4 April 2017.

90 Reuters, UPDATE 1-IMF delays Mongolia bailout due to banking requirements for foreign firms, 2 May 2017, <http://www.reuters.com/article/mongolia-economy-idUSL4N1I41PL>, retrieved 4 April 2017; Reuters, Mongolia wants to resolve mine dispute with Rio Tinto by early 2014, 21 November 2013, <http://www.reuters.com/article/mongolia-rio-idUSL4N0J605I20131121>, retrieved 4 April 2017.



This disagreement continued until November of 2013, when the GoM announced its desire to resolve the dispute with Rio Tinto and Turquoise Hill.<sup>92</sup> By that time, Rio Tinto had reportedly laid off 1,700 of its workers at Oyu Tolgoi, a move that may have motivated the GoM to resolve the dispute.<sup>93</sup> Furthermore, in addition to volatile commodity prices, the cancellation of several large investment deals in 2012 lowered the amount of Foreign Direct Investment (FDI) that Mongolia's economic growth had been heavily dependent upon.<sup>94</sup> This also possibly further weakened the GoM's bargaining position towards Rio Tinto.

At the end of 2015, the GoM and Rio Tinto agreed to a settlement that enabled the second phase expansion of the Oyu Tolgoi mine.<sup>95</sup> Contrary to the GoM's previous demands, the original terms of the 2009 Investment Agreement did not change. Rio Tinto and Turquoise Hill Resources paid an additional US\$ 30 million (instead of the demanded US\$ 300 million) in taxes. Furthermore, Rio Tinto gave up a smelter royalty and agreed to pay the 10 months' worth of royalties that the GoM argued were still owed by the company. Together, these three items were reportedly valued at up to US\$ 148 million, less than half of what the GoM had initially sought.<sup>96</sup> A Rio Tinto spokesperson stated that this was a small price to pay to keep the terms of the 2009 Investment Agreement intact.<sup>97</sup>

On the 15<sup>th</sup> of January 2018, Turquoise Hill Resources announced that it had received a tax claim from the Mongolian Tax Authority, requiring it to pay an additional US \$155 million in taxes. No details were provided, and the company states that it is evaluating the tax claim.<sup>98</sup>

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- 91 In a report by the Sustainable Development Strategy Institute, the following is stated to describe Oyu Tolgoi's context: *"In summary, the [Shareholders Agreement] of establishment of this joint venture cuts Mongolia completely out of the value chain around OT while strangling it with enormous liabilities and no legal way to protect itself or its strategic assets. It effectively delivers to Turquoise Hill Resources the entirety of OT's value, including 100% of the economic value of Mongolia's 34% equity stake, while leaving Mongolia with bankruptcy inducing indebtedness and a lack of control or oversight mechanisms.50 The SA fails completely to protect the interests of the Government of Mongolia and leaves Mongolia with debt."* Sustainable Development Strategy Institute, Investment Treaties Between Mongolia and EU states: Implications for Mongolia's Development Prospects, page 21, 14 January 2016, [http://www.oefse.at/fileadmin/content/Downloads/tradeconference/Jargalsaikhan\\_Investment\\_Treaties\\_Between\\_Mongolia\\_and\\_EU\\_states\\_-\\_Implications\\_for\\_Mongolias\\_Development\\_Prospects.pdf](http://www.oefse.at/fileadmin/content/Downloads/tradeconference/Jargalsaikhan_Investment_Treaties_Between_Mongolia_and_EU_states_-_Implications_for_Mongolias_Development_Prospects.pdf), retrieved 4 April 2017.
- 92 Reuters, Mongolia wants to resolve mine dispute with Rio Tinto by early 2014, 21 November 2013, <http://www.reuters.com/article/mongolia-rio-idUSL4N0J605I20131121>, retrieved 4 April 2017.
- 93 Reuters, Mongolia wants to resolve mine dispute with Rio Tinto by early 2014, 21 November 2013, <http://www.reuters.com/article/mongolia-rio-idUSL4N0J605I20131121>, retrieved 4 April 2017.
- 94 Mining Weekly, Turquoise Hill rejects Mongolian review of mining contract, 15 October 2012, [http://www.miningweekly.com/article/turquoise-hill-rejects-review-mongolian-of-mining-contract-2012-10-15/rep\\_id:3650](http://www.miningweekly.com/article/turquoise-hill-rejects-review-mongolian-of-mining-contract-2012-10-15/rep_id:3650), retrieved 6 October 2017.
- 95 Mining.com, Rio Tinto closes \$4.4 billion financing deal for Oyu Tolgoi mine, 15 December 2015, <http://www.mining.com/rio-tinto-closes-4-4-billion-financing-deal-for-oyu-tolgoi-mine/>, retrieved 4 April 2017.
- 96 The Sydney Morning Herald, Rio Tinto's Mongolian copper mining dream lives on, but at a cost, 19 May 2015, <http://www.smh.com.au/business/mining-and-resources/rio-tintos-mongolian-copper-mining-dream-lives-on-but-at-a-cost-20150519-gh53bn.html>, retrieved 8 August 2017.
- 97 Reuters, UPDATE 1-IMF delays Mongolia bailout due to banking requirements for foreign firms, 2 May 2017, <http://www.reuters.com/article/mongolia-economy-idUSL4N1I41PL>, retrieved 4 April 2017.
- 98 Turquoise Hill Resources, Oyu Tolgoi receives Tax Act from Mongolian Tax Authority, 15 January 2018, [http://www.turquoisehill.com/s/news\\_releases.asp?ReportID=813054](http://www.turquoisehill.com/s/news_releases.asp?ReportID=813054), retrieved 20 January 2018.

### 3.3 The Government of Mongolia's role in Oyu Tolgoi negotiations

The 2009 signing of the Investment Agreement between Rio Tinto, Turquoise Hill Resources and the GoM involved Mr Sangajev Bayartsogt, then the Minister of Finance. Together with the Minister of Mineral Resources and Energy and the Minister of Nature, Environment and Tourism, Mr Bayartsogt represented the GoM in the negotiations.<sup>99</sup>

The 2013 Offshore Leaks database, as well as the research that followed, showed that Mr Bayartsogt possessed US\$ 1 million in an undisclosed Swiss bank account that had been excluded from his income for Mongolian income tax purposes. In response to this revelation, Mr Bayartsogt stated that only US\$ 200,000 of the amount on the Swiss account belonged to him, and that this was income from a family wheat business. The account, according to Bayartsogt, had been opened to trade in international stock and would soon be closed.<sup>100</sup> The connection between the US\$ 1 million sum and Mr Bayartsogt's former government position as Minister of Finance were reportedly widely commented upon online.<sup>101</sup> There is however no proof that the US\$ 1 million sum in Mr Bayartsogt's Swiss bank account has any relation to the Oyu Tolgoi mine, or any indication that he acquired the sum through corrupt practices.

What is important about the revelation is that it shows that Mongolia's Finance Minister – arguably the GoM's most senior authority on the matter of taxes – opened a foreign account without disclosing any of the income on that account on his tax returns, thereby possibly evading his own country's income taxes. In his defence, Mr Bayartsogt claimed that no income was made on this US\$ 1 million sum. He implied that as the money simply sat idle, the bank account was therefore not reported in his tax returns.<sup>102</sup> There is arguably little economic rationale for depositing \$1 million in a Swiss bank account only for the money to sit idly without generating profit. Considering that Mongolia's highest authority in tax matters conducted his own tax matters irresponsibly at best, and with fraudulent intent at worst, begs the question of whether the GoM was capable of serving the interests of the country's people during its negotiations concerning Oyu Tolgoi.

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99 The Government of Mongolia, Ivanhoe Mines Mongolia Inc LLC, Ivanhoe Mines Ltd, and Rio Tinto International Holdings Limited, Investment Agreement, 6 October 2009, [http://www.turquoisehill.com/i/pdf/Oyu\\_Tolgoi\\_IA\\_ENG.PDF](http://www.turquoisehill.com/i/pdf/Oyu_Tolgoi_IA_ENG.PDF), retrieved 8 August 2017.

100 International Consortium of Investigative Journalists, Disclosure of secret offshore documents may force top Mongolian lawmaker to resign, 3 April 2013, <https://www.icij.org/investigations/offshore/disclosure-secret-offshore-documents-may-force-top-mongolian-lawmaker-resign/>, retrieved 16 October 2017.

101 The Mongolist, Continuing Analysis: S. Bayartsogt and the ICIJ Report, 5 April 2013, <http://www.themongolist.com/blog/parliament/66-continuing-analysis-s-bayartsogt-and-the-icij-report.html>, retrieved 15 October 2017.

102 International Consortium of Investigative Journalists, Disclosure of secret offshore documents may force top Mongolian lawmaker to resign, 3 April 2013, <https://www.icij.org/investigations/offshore/disclosure-secret-offshore-documents-may-force-top-mongolian-lawmaker-resign/>, retrieved 16 October 2017.

## 4 Tax avoidance and minimisation

The development of the Oyu Tolgoi mine is financed through loans provided by the Canadian majority shareholder owner, Turquoise Hill Resources Ltd,<sup>103</sup> which itself is owned by Rio Tinto. Once Turquoise Hill had raised the capital to finance Oyu Tolgoi, the sum was moved to Movele SARL, one of its subsidiaries in Luxembourg.<sup>104</sup>

Since 2012, Movele has annually lent out the finance package for Oyu Tolgoi to a related Dutch company called Oyu Tolgoi Netherlands BV, which directly owns Oyu Tolgoi LLC in Mongolia. Every year, Oyu Tolgoi Netherlands BV provides loans of an approximately equal size to Oyu Tolgoi LLC, which uses them to finance the development of the Oyu Tolgoi mine. The way in which Oyu Tolgoi's finances have been structured appears to have been fiscally motivated, and allows Turquoise Hill and its corporate group to avoid and minimise taxes in both Mongolia and Canada. The following section elaborates on the motivation for this fiscal structure and its impacts on tax revenue.

### 4.1 Loans from Luxembourg

The loans provided by Turquoise Hill Resources to Oyu Tolgoi LLC flow through Movele SARL, one of its subsidiaries in Luxembourg. Some of these loans go from Movele (in Luxembourg) directly to Oyu Tolgoi LLC (in Mongolia), while others first pass through the Dutch Turquoise Hill Resources subsidiary (Oyu Tolgoi Netherlands BV). The Dutch subsidiary then provides the loans to Oyu Tolgoi LLC in Mongolia. By doing so, Movele finances Oyu Tolgoi LLC, both directly and indirectly, through the Netherlands. This financing structure has been in place at least since 2011, and the most recent publicly available financial information (from 2015) indicates that it still continues. The figures for these loans are shown in the tables below.

**Table 1 Direct loans from Luxembourg (Movele) to Mongolia (Oyu Tolgoi LLC) x US\$1000<sup>105</sup>**

	2011	2012	2013	2014	2015	2016	Debt avg/ interest total
Debt	3,473,463	3,092,822	3,302,462	2,995,437	2,697,755	3,176,169	<b>3,112,388</b>
Interest	120,438	197,803	209,668	220,003	184,319	n.a.	<b>932,229</b>

<sup>103</sup> Turquoise Hill Resources, Oyu Tolgoi: Advancing value, creating options, August 2017, <http://www.turquoisehill.com/i/pdf/ppt/Presentation-Aug-2017-FINAL.pdf>, retrieved 2 January 2018.

<sup>104</sup> Turquoise Hill Resources, MD&A and Financial Statements, 31 December 2016, <http://www.turquoisehill.com/i/pdf/2016-12-31-TRQ-FS-and-MDA.pdf>, 10 April 2017; Turquoise Hill Resources, MD&A and Financial Statements 2015, 31 December 2015, <http://www.turquoisehill.com/i/pdf/TRQ-Q4-2015.pdf>, 10 April 2017.

<sup>105</sup> Movele Sarl, Annual accounts for the years 2011-2016. These annual accounts can be retrieved through the Luxembourg chamber of commerce, which can be accessed here: <https://www.rclsl.lu/>.

Table 1 shows Movele’s loan financing for the Oyu Tolgoi LLC mine in Mongolia. The loans amount to some US \$3.1 billion at the end of each year during the period between 2011 and 2015. The accrued interest that Oyu Tolgoi LLC owes to Movele SARL on these loans amounts to a total of US\$ 932 million during this same period. This US\$ 932 million in interest expenses lowers Oyu Tolgoi LLC’s taxable profit, and thereby diminishes the taxable base and the tax revenue for Mongolia. In response to these findings, Turquoise Hill Resources and Rio Tinto stated that Movele no longer provides direct loans to Oyu Tolgoi LLC.

Since its incorporation, Movele has had one part-time employee, while Oyu Tolgoi Netherlands BV (which is managed by a Dutch trust company called Intertrust<sup>106</sup>) has had no employees whatsoever. This lack of employees contrasts with the fact that both of these companies are responsible for billion dollar loans on an annual basis. The absence of employees indicates that these two Turquoise Hill Resources subsidiaries function as mailbox companies: existing on paper, but undertaking no real economic activity. Decisions on the financing-related operations of the companies are clearly made elsewhere.

**Table 2 Indirect loans from Luxembourg (Movele SARL) passing through the Netherlands (Oyu Tolgoi Netherlands BV) to Mongolia (Oyu Tolgoi LLC) x US\$1,000<sup>107</sup>**

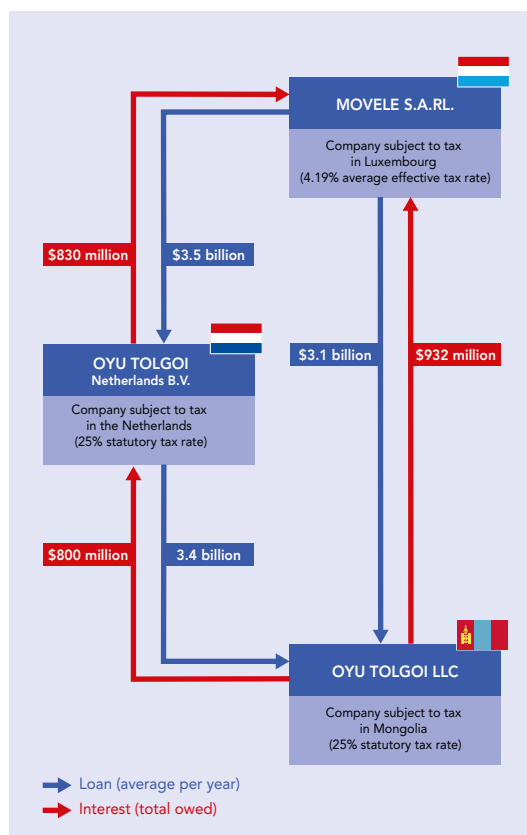
	2012	2013	2014	2015	2016	Loan avg/ interest total
<b>What Oyu Tolgoi LLC (MNG) owes to Oyu Tolgoi Netherlands BV (NL) Interest</b>						
Loans	2,093,003	3,529,244	3,905,517	4,120,431	n.a.	<b>3,412,049</b>
Interest	103,860	215,848	245,631	264,145	n.a.	<b>799,833</b>
<b>What Oyu Tolgoi Netherlands (NL) owes to Movele SARL (LUX)</b>						
Loans	2,433,884	3,598,532	3,924,163	4,188,308	n.a.	<b>3,536,222</b>
Interest	89,585	198,241	246,273	265,734	n.a.	<b>829,483</b>

The figures in Table 2 show that between 2012 and 2015, the amounts of debt and interest owed by Oyu Tolgoi LLC to Oyu Tolgoi Netherlands BV were nearly equal to the amounts owed by Movele SARL to Oyu Tolgoi Netherlands BV. This suggests that the Dutch subsidiary was being used as a conduit for financial flows running from Movele in tax haven Luxembourg to Oyu Tolgoi LLC’s mine in Mongolia. The average of both loans was around US\$ 3.5 billion, while the interest over these loans totalled about US\$ 800 million over four years. When paid out, this interest lowers Oyu Tolgoi LLC’s taxable profit and Mongolia’s tax revenue, while increasing the taxable profit at Movele in Luxembourg.

106 Oyu Tolgoi Netherlands BV, like Turquoise Hill Netherlands Coöperatief, is registered at Prins Bernhardplein 200, the address of Intertrust. Oyu Tolgoi Netherlands BV, 2015 annual report, 22 December 2016, [www.kvk.nl](http://www.kvk.nl), retrieved 6 September 2017. Turquoise Hill Netherlands Coöperatief U.A., 2015 Annual Report, 22 December 2016, [www.kvk.nl](http://www.kvk.nl), retrieved 6 September 2017.

107 Oyu Tolgoi Netherlands BV, annual reports for the years from 2012 until 2016. These reports can be retrieved from the Dutch Chamber of Commerce: <https://www.kvk.nl/zoeken/> (website in Dutch).

**Figure 4 Tax avoidance structure with Turquoise Hill Resources subsidiaries used to finance Oyu Tolgoi (underlying data for 2011-2015)<sup>108</sup>**



The nearly US\$ 800 million in interest expenses for Oyu Tolgoi LLC has led, and if continued in subsequent years will continue to lead, to a matching decrease in the company's taxable profit. In turn, this will likely cause a decrease in the company's taxable base and tax revenue losses for the Mongolian state.<sup>109</sup> In short, Oyu Tolgoi LLC is less exposed to Mongolia's 25 per cent corporate income tax rate as it has less profit to be taxed on. Furthermore, considering the GoM's 34 per cent ownership of the Oyu Tolgoi mine, a third of any dividends paid out by Oyu Tolgoi LLC would go to the GoM. Interest payments made by Oyu Tolgoi LLC lower the company's profits, and thereby limit its ability to pay out such dividends. The interest income made by Movele, on the other hand, belongs solely to Turquoise Hill Resources.

The loans described above indicate a tax avoidance structure that appears as shown in figure 4.

The Dutch subsidiary Oyu Tolgoi Netherlands BV had higher interest expenses for the loan it received from Movele than its interest income over the loan it provided to Oyu Tolgoi LLC. This is another indication that the Dutch company functions solely as a conduit. The fact that the Dutch entity paid no income taxes in the Netherlands between 2012 and 2015 also points to a conduit arrangement.

108 Oyu Tolgoi Netherlands BV, annual reports for the years from 2012 until 2016. These reports can be retrieved from the Dutch Chamber of Commerce: <https://www.kvk.nl/zoeken/> (website in Dutch). Movele Sarl, Annual accounts for the years 2011-2016. These annual accounts can be retrieved through the Luxembourg chamber of commerce, which can be accessed here: <https://www.rcsl.lu/>.

109 Even though this is highly probable, the lack of transparency by Oyu Tolgoi LLC in that it does not publish its profit and loss accounts, makes this impossible to verify. In their review reply to this report, Turquoise Hill Resources and Rio Tinto report that Oyu Tolgoi LLC has been loss making since construction on the Oyu Tolgoi mine started. Whether Oyu Tolgoi LLC's interest expenses eventually lead to a lower taxable base depend on whether Oyu Tolgoi LLC will be able to use the tax credits related to its losses to offset future profits. Considering these losses can be carried forward for eight years under Mongolian tax law, it seems likely that the company will be able to make use of these tax credits.

The Dutch route could also be used to avoid dividend taxes and capital gains taxes: OT Netherlands BV is owned by Turquoise Hill Netherlands Coöperatief, which is registered as a cooperative. The use of this cooperative legal form has possibly allowed Turquoise Hill Resources to avoid Dutch withholding taxes on dividends.<sup>110</sup> Furthermore, should Rio Tinto and Turquoise Hill Resources ever choose to sell the Oyu Tolgoi mine, they could instead choose to sell Oyu Tolgoi Netherlands BV, the Dutch subsidiary that owns the mine. By doing so, the company would then avoid paying Mongolian tax on the difference between the purchase value of the mine and the value of its sale, the so-called capital gains tax.

## Box 2 Repeated reports on structural tax avoidance by multinational corporations

Tax avoidance by multinationals has been widely reported by media in recent years, in part due to repeated data leaks among companies that facilitate tax avoidance through their consulting or the incorporation services they provide. The most significant of these recent leaks has been the Panama<sup>111</sup> and Paradise<sup>112</sup> papers, which have shown how many of the world's celebrities, political dignitaries and rulers, and first and foremost multinational corporations are structurally avoiding taxes in the jurisdictions in which they work and operate. The role that states, and specifically EU tax havens, play within this international system of tax avoidance has been illustrated through the EU's own enforcement of its state aid rules. In these so-called state aid cases,<sup>113</sup> the EU has called upon several of its member states – including the Netherlands, Luxembourg and Ireland – to levy more taxes from specific multinationals registered within their jurisdictions. Their argument is that the current fiscal arrangements provided to these companies amounts to illegal state aid. The issue of tax avoidance discussed within this report is, therefore, not specific to the case of Rio Tinto and Oyu Tolgoi, but should be seen within the wider context of multinational corporations structurally shifting profits to tax havens and using gaps in tax legislation to minimise their tax obligations. In this way they deprive states of the tax revenues needed to provide essential services like healthcare and education for their citizens.

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- 110 This tax avoidance scheme was possible until January 1<sup>st</sup> 2018, but Dutch law has since been changed, removing the exemption from dividend tax for Cooperatives. However, considering the current Dutch Government's plans to completely abolish the Dutch dividend tax, it seems likely that Rio Tinto will remain able to use its Dutch ownership construction to avoid paying dividend tax on profits flowing from Mongolia, through the Netherlands, on to Canada. Meijburg & Co, Belastingplan 2018: Dividendbelasting, 19 September 2017, <https://meijburg.nl/nieuws/belastingplan-2018-dividendbelasting>, retrieved 6 December 2017; VVD, CDA, D66 and Christenunie, Vertrouwen in de toekomst, 10 October 2017, <https://www.kabinetformatie2017.nl/documenten/publicaties/2017/10/10/regeerakkoord-vertrouwen-in-de-toekomst>, retrieved on 4 December 2017.
- 111 International Consortium of Investigative Journalists, Panama Papers, no date, <https://panamapapers.icij.org/>, retrieved on 30 December 2017.
- 112 International Consortium of Investigative Journalists, Paradise Papers, no date, <https://www.icij.org/investigations/paradise-papers/>, retrieved on 30 December 2017.
- 113 European Commission, State aid Cases, no date, [http://ec.europa.eu/competition/state\\_aid/register/](http://ec.europa.eu/competition/state_aid/register/), retrieved on 10 January 2018.

### ◉ Box 2 Repeated reports on structural tax avoidance by multinational corporations

The mining industry is specifically known for using intricate schemes to avoid paying taxes.<sup>114</sup> Mining companies have access to an array of dubious measures that allow them to lower their tax bills in the countries where they operate, including transfer mispricing of management fees and mineral trades,<sup>115</sup> as well as so-called cross-currency interest rate swaps.<sup>116</sup> Generally, such actions increase costs and lower profits at the operational level while increasing profits in low-tax jurisdictions. At the moment, Rio Tinto is disputing a US\$ 360 million tax bill from the Australian Government, which alleges that the company has used transfer mispricing to shift profits to a subsidiary in low-tax Singapore in order to avoid Australian taxes.<sup>117</sup> As Oyu Tolgoi LLC is not required to publish its annual accounts, it was impossible to look into the company's financial management to investigate whether Rio Tinto is employing any such measures in the case of Oyu Tolgoi.

## 4.2 Tax deal in Luxembourg: avoiding Canadian taxes

The previous section detailed how Turquoise Hill Resources finances its Mongolian Oyu Tolgoi mine with loans provided by a mailbox subsidiary located in tax haven Luxembourg. The use of this mailbox subsidiary appears entirely fiscally motivated, and aimed exclusively at avoiding corporate income tax elsewhere. Formally, corporate income in Luxembourg was subject to a statutory tax rate between 28.8 and 29.2 per cent from 2011 to 2015.<sup>118</sup> However, Luxembourg's tax authorities have been known to provide fiscal incentives to companies willing to register in Luxembourg. In 2014, this was illustrated by the Luxembourg Leaks,<sup>119</sup> which showed how corporate clients of accounting firm PricewaterhouseCoopers had been provided with tax rulings by Luxembourg's tax authorities.

114 Natural Resource Governance Institute, Preventing Tax Base Erosion in Africa: a Regional Study of Transfer Pricing Challenges in the Mining Sector, July 2016, [https://resourcegovernance.org/sites/default/files/documents/nrgi\\_transfer-pricing-study.pdf](https://resourcegovernance.org/sites/default/files/documents/nrgi_transfer-pricing-study.pdf), retrieved 2 January 2018.

115 Publish What You Pay, Many ways to lose a billion, June 2017, <http://www.publishwhatyoupay.org/wp-content/uploads/2017/07/PWYP-Report-ManyWaysToLoseABillion-EN-INTERACTIVE.pdf>, retrieved 2 January 2018.

116 ABC News, The tax trick big miners use to avoid paying millions, 6 November 2017, <http://www.abc.net.au/news/2017-11-06/ato-investigating-multinationals-amid-paradise-papers-leak/9075642>, retrieved 2 January 2018; Australian Taxation Office, Arrangements involving related party foreign currency denominated finance with related party cross currency interest rate swaps, 26 April 2016, <http://law.ato.gov.au/atolaw/view.htm?docid=%22TPA%2FTA20163%2FNAT%2FATO%2F00001%22>, retrieved 2 January 2018.

117 Financial Times, Rio Tinto to fight \$360m Australian tax bill, 5 April 2017, <https://www.ft.com/content/676d74c0-1a11-11e7-bcac-6d03d067f81f>, retrieved 10 December 2017.

118 KPMG, Corporate tax rates table, no date, <https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html>, retrieved on 5 December 2017.

119 International Consortium of Investigative Journalists, Luxembourg Leaks, no date, <https://www.icij.org/investigations/luxembourg-leaks/>, retrieved on 30 December 2017.

These tax rulings, also referred to as “comfort letters”, at times resulted in the firm’s clients owing as little as 1 per cent tax over their income.<sup>120</sup>

Looking at Movele’s tax payment, it seems that a similar tax ruling was agreed between Turquoise Hill Resources’s Luxembourg subsidiary Movele and the country’s tax authorities. Table 3 below shows Movele’s pre-tax profit, its income tax expenses, and its effective tax rates between 2010 and 2016. The effective tax rates, an indicator used to determine how much corporate income tax a company owes after special arrangements such as tax incentives or other tax rulings with authorities have been taken into account, instead of what it is expected to owe under statutory tax rates that apply to all tax payers equally, was calculated by dividing Movele’s income tax by its pre-tax profit.

**Table 3 Movele’s tax expense and effective tax rate in Luxembourg x US\$1000<sup>121</sup>**

	2010	2011	2012	2013	2014	2015	2016	Total
Pre-tax profit	-800	120,234	301,282	425,260	465,438	449,848	353,952	<b>2,116,913</b>
Income tax	0	0	0	58	15,566	15,033	58,000	<b>88,656</b>
Effective tax rate	0.0%	0.0%	0.0%	0.01%	3.34%	3.34%	16.39%	<b>16.39%</b>

Between 2010 and 2016 Movele accumulated over US\$ 2.1 billion in profits, over which it paid close to US\$ 89 million, or 4.31 per cent, in tax. Movele’s profits appear to be almost entirely the result of the interest it received over the loans provided, both directly and indirectly, to Oyu Tolgoi LLC in Mongolia. It seems likely that Movele was registered in Luxembourg to allow it to make use of this extremely low effective tax rate, which allowed it to significantly limit the tax expenses of Turquoise Hill Resources’ corporate group.

The alternative option, without tax avoidance, would be for Turquoise Hill Resources to provide the loan to Oyu Tolgoi LLC directly from its headquarters in Canada.<sup>122</sup> Considering that the company is Canadian without any apparent link to Luxembourg or the Netherlands, this would have been a more logical choice (at least when fiscal incentives are taken out of the equation). If the loans financing the Oyu Tolgoi mine had been provided by Turquoise Hill Resources’ parent company in Canada, the interest income on those loans would have been income for the parent company, and would have consequently been subject to Canadian corporate income tax rates. Canada’s income tax rate between 2010 and 2015 varied between 26.5 and 31 per cent.

120 International Consortium of Investigative Journalists, Leaked Documents Expose Global Companies’ Secret Tax Deals in Luxembourg, 5 November 2014, <https://www.icij.org/project/luxembourg-leaks/leaked-documents-expose-global-companies-secret-tax-deals-luxembourg>, retrieved on 3 July 2017; The Guardian, Luxembourg tax files: how tiny state rubber-stamped tax avoidance on an industrial scale, 5 November 2014, <https://www.theguardian.com/business/2014/nov/05/spluxembourg-tax-files-tax-avoidance-industrial-scale>, retrieved on 3 July 2017.

121 Movele Sarl, Annual accounts for the years 2010-2016. These annual accounts can be retrieved through the Luxembourg chamber of commerce, which can be accessed here: <https://www.rcls.lu/>.

122 Turquoise Hill Resources, Contacts & Offices, no date, [http://www.turquoisehill.com/s/contacts\\_and\\_offices.asp](http://www.turquoisehill.com/s/contacts_and_offices.asp), retrieved on 3 July 2017.



Table 4 below shows how much tax Turquoise Hill Resources would have owed to Canadian tax authorities if it had structured its finance in this manner, and how much corporate income tax the company has avoided by using its Luxembourg mailbox subsidiary Movele.

**Table 4 Canadian corporate income tax revenue loss and tax avoided by Movele x US\$1000<sup>123</sup>**

	2010	2011	2012	2013	2014	2015	2016	Total
Pre-tax profit	-800	120,234	301,282	425,260	465,438	449,848	353,952	<b>2,116,913</b>
Canadian tax rate <sup>124</sup>	31%	28%	26%	301,282	301,282	301,282	301,282	<b>301,282</b>
Canadian tax revenue loss	0	33,666	78,333	26%	26%	26%	26%	<b>26%</b>
Tax avoided by Movele	0	33,666	78,333	78,333	78,333	78,333	78,333	<b>78,333</b>

If the loans for Oyu Tolgoi LLC had been provided by Turquoise Hill Resources' parent company in Canada, Canadian authorities would have been able to tax an additional US\$ 2.1 billion in profit. Based on the Canadian statutory tax rates, such an increase in the taxable base at Turquoise Hill Resources would have led to a total increase in Canadian tax revenues of US\$ 558.9 million. In this hypothetical case – in which Turquoise Hill Resources had not employed a tax avoidance strategy – the company would have had to pay an additional US\$ 470 million. This means that the company dodged taxes totalling nearly half a billion US dollars between 2010 and 2016 by employing this tax avoidance structure. While paying only about US\$ 88.7 million in taxes in Luxembourg, Turquoise Hill Resources deprived its home state, Canada, of a large amount of tax revenues.

In response to these findings, Rio Tinto and Turquoise Hill Resources wrote that the funding structure for Oyu Tolgoi was confirmed with the Canadian Revenue Authority through a tax ruling. Tax rulings, as explained above in the case of Luxembourg, are fiscal tools provided by tax authorities wherein prospective tax practices proposed by a multinational are approved by the respective tax authorities.<sup>125</sup> This means that Canadian tax authorities were aware of the Oyu Tolgoi finance structure employed by Turquoise Hill Resources in advance.

By setting up two mailbox subsidiaries – Movele and Oyu Tolgoi Netherlands BV – Rio Tinto and Turquoise Hill Resources have managed to create a paper reality that obscures the fact that they have no real connection to these countries. Ultimately, this has enable them to avoid nearly half a billion US dollars in tax payments over a seven-year period.

123 Movele Sarl, Annual accounts for the years 2010-2016. These annual accounts can be retrieved through the Luxembourg chamber of commerce, which can be accessed here: <https://www.rclsl.lu/>. The Canadian tax rates were retrieved using the following source: KPMG, Corporate tax rates table, no date, <https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html>, retrieved on 5 December 2017.

124 These statutory corporate income tax rates were used in Canada in the corresponding year. The statutory tax rates likely do not correspond exactly with what Turquoise Hill Resources would have owed over the interest income on the loans but are likely to be a close estimate.

125 Rio Tinto and Turquoise Hill Resources email reply to SOMO's review request, received on 17 January 2018.

### 4.3 Oyu Tolgoi's abusive Investment Agreement – minimising Mongolian tax obligations

In addition to avoiding corporate income taxes in Canada, Turquoise Hill Resources has also managed to lower withholding taxes on interest it would otherwise have been required to pay in Mongolia. Usually, withholding taxes are levied on payments such as interest or royalties made from resident companies to companies abroad. This is done to ensure that profits are not shifted out of the country by foreign investors or domestic companies applying profit-shifting methods using passive income payments. Technically, withholding taxes are paid by the receiving party abroad, in the so-called residence state. For example, in the case of loans running from Movele to Oyu Tolgoi LLC, as described above, Movele would be the party paying withholding taxes on interest to the Mongolian Government. For interest payments coming from a Mongolian company and going to a company outside of Mongolia, Mongolian tax authorities generally levy a 20 per cent withholding tax on the payment. The rate of this withholding tax on interest may be affected by the bilateral Double Taxation Agreements (DTAs) that Mongolia has with a sizeable number of countries around the world, and which often reduce the rate to between 5 and 15 per cent.<sup>126</sup>

The previous section discussed how the loan financing of the Oyu Tolgoi mine significantly decreased Oyu Tolgoi LLC's taxable income in Mongolia, while raising the taxable income of Movele in Luxembourg. The large amount of interest owed by Oyu Tolgoi LLC over its borrowings lowers the company's taxable profit, and thereby decreases corporate income tax revenues for Mongolia. As mentioned above, withholding taxes on interest are a tool that allow countries like Mongolia to make sure that even when such loan financing is used, they retain some tax income from the economic activity that takes place within their jurisdiction (e.g. the copper and gold mining at Oyu Tolgoi). With the signing of DTAs or other agreements that reduce such withholding taxes, countries like Mongolia effectively relinquish one of their most important sources of tax revenue from foreign direct investment.

When Turquoise Hill Resources started investing heavily in Oyu Tolgoi in 2011, the Mongolian Government had a DTA in place with Luxembourg and the Netherlands that lowered withholding taxes on interest payments between these two countries to 10 per cent. By routing its loans to Oyu Tolgoi LLC through the Netherlands and Luxembourg, Turquoise Hill Resources was able to use those countries' DTAs with Mongolia, thereby reducing the withholding tax on interest the GoM was allowed to levy on those loans. The general practice of setting up a mailbox company in a country for the sole purpose of making use of beneficial tax treaties is called 'treaty shopping'. International efforts to limit this type of treaty abuse are ongoing under the OECD's Base Erosion and Profit

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126 PricewaterhouseCoopers, Mongolia: Corporate – Withholding taxes, no date <http://taxsummaries.pwc.com/ID/Mongolia-Corporate-Withholding-taxes> retrieved 8 August 2017.

Shifting Project.<sup>127</sup> However, as long as treaty shopping remains possible, signing DTAs that lower the withholding taxes of countries like Mongolia will allow companies to avoid taxes in those countries.

As mentioned earlier, the publication of the 2012 IMF report on problematic Mongolian DTAs,<sup>128</sup> including those with Luxembourg and the Netherlands, led the GoM to unilaterally terminate its DTAs with these countries.<sup>129</sup> In doing so, Mongolia attempted to regain control over the taxes it could levy on the financial flows leaving its territory. However, for Oyu Tolgoi, the largest single investment in Mongolia, this termination did not affect its tax obligations because Rio Tinto's Investment Agreement with Mongolia "stabilises" treaties that were in force at the time of signing in 2009.<sup>130</sup> The stabilisation clause determined that the interest payments made by Oyu Tolgoi LLC would be subject to a maximum of 10 per cent withholding tax, as set by the cancelled tax treaties with the Netherlands and Luxembourg. This stabilisation has meant that the GoM is not legally allowed to change the tax it levies on interest flows to the Netherlands and Luxembourg.<sup>131</sup>

By financing Oyu Tolgoi LLC primarily through loans, the company's profits are heavily reduced by its interest costs. This in turn reduces the corporate income tax revenue the Mongolian state receives from the mine. Because these interest flows diminish Oyu Tolgoi's taxable base, withholding taxes on interest are an important source of tax income for the GoM from the Oyu Tolgoi mine. By signing the Oyu Tolgoi Investment Agreement, the GoM effectively halved this revenue source from 20 per cent to 10 per cent of the interest payments made by Oyu Tolgoi LLC.

In response to this report, Rio Tinto and Turquoise Hill Resources stated that the same lowering of the withholding tax rate – from 20 per cent to 10 per cent – is enshrined in Mongolia's DTA with Canada.<sup>132</sup> Therefore, providing finance from Canada instead of Luxembourg would have caused a similar reduction in the withholding tax rate applied to interest payments by Oyu Tolgoi. In fact, the lowering of withholding tax rates in DTAs between developing countries that mostly receive FDI, like Mongolia, and developed countries that are the source of this FDI, like Canada, generally leads to a decrease in the taxing rights of the developing country.<sup>133</sup> The asymmetrical relation

127 Business Dictionary, Treaty shopping, no date, <http://www.businessdictionary.com/definition/treaty-shopping.html>, retrieved 4 December 2017; OECD, Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report, 5 October 2015, <http://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report-9789264241695-en.htm>, retrieved 4 December 2017.

128 IMF, Mongolia: Technical Assistance Report – Safeguarding Domestic Revenue – A Mongolian DTA Model, November 2012, <https://www.imf.org/external/pubs/ft/scr/2012/cr12306.pdf>, retrieved 8 November 2017.

129 Reuters, Special report: In tax case, Mongolian is the mouse that roared, 16 July 2013, <https://www.reuters.com/article/us-dutch-mongolia-tax/special-report-in-tax-case-mongolia-is-the-mouse-that-roared-idUSBRE96F0B620130716>, retrieved 16 August 2017.

130 Reuters, Special report: In tax case, Mongolian is the mouse that roared, 16 July 2013, <https://www.reuters.com/article/us-dutch-mongolia-tax/special-report-in-tax-case-mongolia-is-the-mouse-that-roared-idUSBRE96F0B620130716>, retrieved 16 August 2017.

131 The Government of Mongolia, Ivanhoe Mines Mongolia Inc LLC, Ivanhoe Mines Ltd, and Rio Tinto International Holdings Limited, Investment Agreement, 6 October 2009, [http://www.turquoisehill.com/i/pdf/Oyu\\_Tolgoi\\_IA\\_ENG.PDF](http://www.turquoisehill.com/i/pdf/Oyu_Tolgoi_IA_ENG.PDF), retrieved 8 August 2017.

132 Rio Tinto and Turquoise Hill Resources email reply to SOMO's review request, received on 17 January 2018.

133 Tax Justice Network, Source and Residence Taxation, 15 September 2005, <http://www.taxjustice.net/cms/upload/pdf/Sourceresidence.pdf>, retrieved on 15 December 2017.

between such countries makes it highly disadvantageous for a country like Mongolia to sign a DTA that lowers withholding tax rates. This is doubly true in the case of possible DTAs with countries like Luxembourg, which provide undue tax benefits to resident companies, and countries like the Netherlands, which function as conduits for investment flows coming from third party states. These countries facilitate tax avoidance schemes like the one detailed in this report.

When the GoM attempted to renegotiate the terms of the Investment Agreement in 2013, the ensuing conflict between Turquoise Hill Resources owner Rio Tinto and the GoM delayed renewed investment in the Oyu Tolgoi mine. Oyu Tolgoi Netherlands' 2015 annual report shows that during the negotiations between the owners of Oyu Tolgoi – most notably Rio Tinto – and the GoM, the company managed to get the government to lower the withholding tax rate on interest paid by Oyu Tolgoi LLC from 10 per cent to 6.6 per cent. Furthermore, this reduction of the withholding tax was applied not only to future payments but also retroactively, affecting all interest owed by Oyu Tolgoi LLC over the previous five years. This allowed Oyu Tolgoi Netherlands BV to decrease the withholding tax it owed to Mongolia by US\$ 27 million.<sup>134</sup> The reason provided for this amendment of the Investment Agreement<sup>135</sup> was that the GoM had been made responsible for all taxes related to the financing of its own 34 per cent stake in the Oyu Tolgoi mine, and was therefore responsible for paying 34 per cent of the withholding taxes on loans provided to the mine.<sup>136</sup>

Because the withholding taxes are paid by the non-domestic party that receives the interest payments – and not by the party that makes the payments – the logic behind this arrangement seems flawed. The objective of withholding taxes is to stop the erosion of the domestic tax base through payments abroad, in this case by making Movele and Oyu Tolgoi Netherlands pay tax on the interest payments they receive. The idea, then, that this withholding tax should be reduced because of the fact that the interest paying party, Erdenes Oyu Tolgoi in this case, is linked to the government, makes no sense. The GoM owns 34 per cent of the company paying the interest (Oyu Tolgoi LLC) and not the companies receiving it (Movele and Oyu Tolgoi Netherlands), and should therefore not be expected to pay withholding taxes on the loans. Furthermore, the fact that the withholding tax rate was lowered only after the conclusion of negotiations in 2015 raises the suspicion that this was simply one of the outcomes of the negotiations, and not an adjustment based on Mongolian tax law. Nevertheless, the adjustment in the agreement further decreased tax expenses for Turquoise Hill Resources (and Rio Tinto).

As discussed at length in this report, the process and contents of the Investment Agreement between the corporate owners of Oyu Tolgoi on the one hand and the GoM on the other can be characterised as abusive. The repeated reduction of the withholding tax has significantly decreased

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134 Oyu Tolgoi Netherlands BV, 2015 annual report, 22 December 2016, [www.kvk.nl](http://www.kvk.nl), retrieved 6 September 2017.

135 This amendment was documented partly in the Investment Agreement and partly in the corresponding Shareholders Agreement between Oyu Tolgoi's shareholders, most notably Rio Tinto and the GoM. These two agreements can be found in the sources below: Erdenes Mongolia LLC, Ivanhoe Oyu Tolgoi (BVI) Ltd, Oyu Tolgoi Netherlands BV, and Oyu Tolgoi LLC, Amended and Restated Shareholders Agreement, article 11.3e, 8 June 2011, <http://www.turquoisehill.com/i/pdf/OT-ARSHA-ENG-2011-06-08-Executed.pdf>, retrieved 8 September 2017; The Government of Mongolia, Ivanhoe Mines Mongolia Inc LLC, Ivanhoe Mines Ltd, and Rio Tinto International Holdings Limited, Investment Agreement, 6 October 2009, [http://www.turquoisehill.com/i/pdf/Oyu\\_Tolgoi\\_IA\\_ENG.PDF](http://www.turquoisehill.com/i/pdf/Oyu_Tolgoi_IA_ENG.PDF), retrieved 8 August 2017.

136 Oyu Tolgoi Netherlands BV, 2015 annual report, 22 December 2016, [www.kvk.nl](http://www.kvk.nl), retrieved 6 September 2017.

any income the GoM can expect to receive from the mine, while the interest paid on the loans to Oyu Tolgoi will likely limit the mine's profitability and any dividends Mongolia can expect to receive. The table below provides an analysis of the withholding tax revenue the GoM has lost as a result of signing the Investment Agreement.

**Table 5 Mongolian withholding tax on interest revenue loss due to the Oyu Tolgoi Investment Agreement x US\$1000**

	2011	2012	2013	2014	2015	Total
Total interest	120,438	287,388	407,908	466,276	450,052	1,732,062
Withholding tax owed in current situation	7,949	18,968	26,922	30,774	29,704	114,316
WHT owed under domestic Mongolian law	24,088	57,478	81,582	93,255	90,011	346,412
Mongolian tax revenue loss	16,139	38,510	54,660	62,481	60,307	232,096

Between 2011 and 2015, interest over the loans provided to Oyu Tolgoi LLC by Movele and Oyu Tolgoi Netherlands amounted to US\$ 1.7 billion. Under the Investment Agreement concerning Oyu Tolgoi, 6.6 per cent withholding tax on that interest was owed to Mongolia, with a total value of US\$ 114 million. If the GoM had negotiated instead the application of its regular domestic 20 per cent withholding tax rate on interest owed by Oyu Tolgoi LLC, Mongolian withholding tax revenues from Oyu Tolgoi would have been three times as high. Consequently, the GoM would have received an extra US\$ 232 million in tax revenue.

To put these figures into context, the GoM's total spending in 2016 was US\$ 1.61 billion.<sup>137</sup> Based on the latest available figures, some 5 per cent of the GoM's annual budget, or US\$ 80 million, is spent on education<sup>138</sup> and the same amount is spent on health.<sup>139</sup> This money is used to provide healthcare and education to Mongolia's population of over 3 million people, meaning that the GoM spends roughly US\$ 27 on healthcare and education per person each year.<sup>140</sup> The Netherlands, in contrast, spends over US\$ 5,700 million on healthcare and over US\$ 2,500 million on education per person per year.<sup>141</sup> Considering that Mongolian tax revenue losses related to Oyu Tolgoi have been close to US\$ 60 million per year over the past three years, it appears that if Oyu Tolgoi paid tax following domestic law instead of the abusive Investment Agreement the GoM would be able to almost double its annual budget for education or healthcare.

137 World Bank, Data: General government final consumption expenditure, no date, <https://data.worldbank.org/>, retrieved 8 August 2017.

138 World Bank, Data: Government expenditure on education, no date, <https://data.worldbank.org/>, retrieved 8 August 2017.

139 World Health Organization, Mongolia, no date, <http://www.who.int/countries/mng/en/>, retrieved 6 December 2017.

140 Central Intelligence Agency, The World Factbook: Mongolia, no date, <https://www.cia.gov/library/publications/the-world-factbook/geos/mg.html>, retrieved 6 December 2017.

141 Rijksoverheid, Overzicht inkomsten en uitgaven Rijksoverheid 2018, no date, <https://www.rijksoverheid.nl/onderwerpen/prinsjesdag/inkomsten-en-uitgaven/overzicht-inkomsten-en-uitgaven-rijksoverheid-2018>, 2 January 2018.

Worldometers, Netherlands Population, no date, <http://www.worldometers.info/world-population/netherlands-population/>, retrieved 6 December 2017.

### Box 3 Oyu Tolgoi phase 2 – International Financial Institutions (inadvertently) supporting tax avoidance and socio-environmental violations

After Rio Tinto managed to resolve its conflict with the Mongolian Government over the division of revenue from Oyu Tolgoi in 2015, the second phase of Oyu Tolgoi could proceed. Subsequently, Rio Tinto managed to attract US\$ 4.4 billion in finance. The funding for phase two of Oyu Tolgoi is coming from banks<sup>142</sup>, export-credit insurance agencies, and national and supranational financial institutions. Notable financial institutions involved in this financing arrangement are the European Bank for Reconstruction and Development (EBRD), the World Bank Group's International Finance Corporation (IFC) and Multilateral Investment Guarantee Agency (MIGA), the Dutch Financierings-Maatschappij voor Ontwikkelingslanden (FMO), Export Development Canada, the Australian Export Finance and Insurance Corporation, and the US Export-Import Bank.<sup>143</sup> Considering the way in which Oyu Tolgoi's finance structure has so far been geared towards tax avoidance, we must question whether the huge amount of public finance coming from these financial institutions – provided by taxpayers in these institutions' respective countries or regions – will feed into the same financial construction and thereby lead to further tax avoidance.

Unlike the open pit mine of phase one, the phase two mine is an underground operation whereby copper and gold ore will be mined through underground explosions. The area around the project is a desert-like region, where herder communities depend upon the scarce water that is available. Phase two is a categorically different type of mining operation from its predecessor: seismic shocks from explosions and surface instability pose serious risks, and the combination of the mine's water consumption, climate variability, and decreased herd mobility may contribute to a decreased availability of water in the region. Even though the need for an updated Environmental and Social Impact Assessment (ESIA) for phase 2 is confirmed by Oyu Tolgoi in the publicly available 2015 Environmental and Social Action Plan, they argue that , the 2012 ESIA covered both phases..<sup>144</sup>

The risks related to environmental and social rights violations, as well as to possible tax avoidance in the financing of Oyu Tolgoi's phase two, should pose serious concerns for the public financial institutions listed above. Through their investment in Oyu Tolgoi, they may become complicit in Rio Tinto's abuses. An upcoming SOMO publication to be published later in 2018 will address the relationship between these public institutions and Oyu Tolgoi.

142 These include Australia & New Zealand Banking Group, Bank of Tokyo-Mitsubishi, BNP Paribas, CIBC, Credit Agricole, HSBC, ING Bank, Intesa Sanpaolo, KfW IPEX-Bank, National Australia Bank, Natixis, Societe Generale, Standard Chartered Bank, Sumitomo Mitsui Banking Corp. This information was found in the source below.

Reuters Eikon database, Oyu Tolgoi, debt structure, retrieved 19 December 2017.

143 Reuters Eikon database, Oyu Tolgoi, debt structure, retrieved 19 December 2017.

144 CEE Bankwatch Network, Oyu Tolgoi Phase 2: Plans, Issues and Risks, 11 February 2016, <https://bankwatch.org/publication/oyu-tolgoi-phase-2-plans-issues-and-risks>, retrieved 12 December 2016.

This is a particularly painful realisation given the small government budgets for education and health – not to mention others – as well as the current austerity measures being implemented in Mongolia as part of an IMF bailout plan.<sup>145</sup>

## 4.4 Total tax losses

The previous chapter provides estimates of the tax Rio Tinto and Turquoise Hill Resources have minimised and avoided in Mongolia and Canada. It should be noted that as all of these tax revenue loss figures are based on a comparison between hypothetical situations and the tax avoidance schemes that are currently being employed, they should be seen only as estimates and not as exact tax revenue losses.

The main components of Rio Tinto's tax avoidance and minimisation scheme that allow it to significantly lower the taxes owed on Oyu Tolgoi's profits, can be summed up as follows:

- ❑ The application of benefits enshrined in defunct Mongolian tax treaties with the Netherlands and Luxembourg, treaties which Mongolia abolished specifically to tackle tax avoidance, to lower withholding taxes on Oyu Tolgoi's interest payments to 10 per cent;
- ❑ A further (retroactive) lowering of withholding taxes to 6.6 per cent in 2015, seemingly as a concession from the Mongolian Government following a dispute with Rio Tinto;
- ❑ The use of a Luxembourg mailbox subsidiary that has enjoyed a very low 4.19 per cent effective tax rate in the past seven years, presumably due to a tax deal with the country's tax authorities.

Based on publicly available information, it has been estimated that US\$ 232 million in Mongolian withholding tax revenue was lost using tax benefits negotiated with the Mongolian Government, while \$470 million in Canadian corporate income tax were avoided using a fiscal scheme. It should be noted that these figures are the revenue loss generated by the avoidance and minimisation of two different types of taxes: withholding tax on interest payments, and corporate income tax due to financing through loans from a tax haven subsidiary. Seeing as both of these types of tax are levied on Oyu Tolgoi's revenue stream, they are interdependent. If Mongolia were to levy a 20 per cent withholding tax on interest paid by Oyu Tolgoi LLC instead of the current 6.6 per cent, this would lead to lower profits generated by Movele in Luxembourg (in the current situation) or Turquoise Hill Resources in Canada (in the hypothetical case where Canadian tax was not being avoided). This increase in withholding taxes paid to Mongolia would then lead to a decrease in tax losses for Mongolia, but would also lead to a decrease of the hypothetically recoverable tax revenue for Canada.

Therefore, an aggregation of the US\$ 232 and US\$ 470 million in unpaid taxes – for a total of \$700 million – slightly overestimates the actual tax revenue gains for Canada, as well as the actual tax revenue losses. The figure should in fact be somewhat lower, although this is impossible to calculate without access to the tax returns of Turquoise Hill Resources and its relevant subsidiaries.

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145 Reuters, Mongolia agrees \$5.5 billion economic bailout plan with IMF, others, 19 February 2017, <https://www.reuters.com/article/us-mongolia-imf/mongolia-agrees-5-5-billion-economic-bailout-plan-with-imf-others-idUSKBN15Y02S>, retrieved 6 December 2017.

## 5 Treaty abuse using Dutch mailbox companies

Oyu Tolgoi LLC – the company controlling the Oyu Tolgoi mining license – is owned by Turquoise Hill Resources' Dutch subsidiary Oyu Tolgoi Netherlands BV, which is in turn owned by Turquoise Hill Netherlands Coöperatief UA.<sup>146</sup> Both of these companies are registered at Prins Bernhardplein 200, the address of the Intertrust trust company. The fact that they are managed by a trust company and report in their most recent annual accounts<sup>147</sup> that they have zero employees is an indication that these Dutch entities are mailbox companies that exist only on paper and undertake no real economic activity in the Netherlands.

The sole reason that these two subsidiaries of Turquoise Hill Resources – and Rio Tinto by extension – were registered in the Netherlands is to make use of the fiscal benefits and/or investment protections enshrined in bilateral treaties the Netherlands has agreed with third countries and that are intended only for Dutch resident companies. In response to these findings, Turquoise Hill Resources and Rio Tinto state that the protection provided under the Netherlands-Mongolia Bilateral Investment Treaty (BIT) was one of the factors that led them to register their subsidiaries in the Netherlands. Canada did not have a BIT in place with Mongolia at the time. Gaining treaty benefits by registering empty conduit entities in a signatory state is an indication of treaty shopping. This occurs when a resident of a third country takes advantage of a treaty between states by setting up a conduit company or another legal entity in a state that has a suitable treaty, only for the purpose of enjoying the benefit of that treaty.<sup>148</sup>

As explained earlier, Oyu Tolgoi Netherlands BV is currently being used as a conduit company for loans going from Luxembourg to Mongolia. This facilitates tax avoidance, and may be used in the future to avoid capital gains tax in the event that Oyu Tolgoi is sold. In the meantime, Turquoise Hill Netherlands Coöperatief UA may be used to avoid dividend taxes on any profit made by Oyu Tolgoi Netherlands BV.

This Dutch mailbox construction can also be used for investment protection; in the case of Oyu Tolgoi for example allowing the company to take Mongolia to court when a law change impacted foreign investors. Since June 1996, a bilateral investment treaty (BIT) has been in place between the Netherlands and Mongolia that provides far-reaching protection for any company from one of these countries that invests in the other. This specific BIT determines that states hosting these companies' investments will refrain from depriving them of their investments;<sup>149</sup> will not hamper or delay any

146 Orbis corporate database, ownership, Rio Tinto Plc, retrieved 4 December 2017.

147 Oyu Tolgoi Netherlands BV, 2015 annual report, 22 December 2016, [www.kvk.nl](http://www.kvk.nl), retrieved 6 September 2017; Turquoise Hill Netherlands Coöperatief U.A., 2015 Annual Report, 22 December 2016, [www.kvk.nl](http://www.kvk.nl), retrieved 6 September 2017.

148 V. Krishna, Treaty Shopping and the Concept of Beneficial Ownership in Double Tax Treaties, August 2009, [http://commonlaw.uottawa.ca/15/index.php?option=com\\_docman&task=doc\\_download&gid=2805](http://commonlaw.uottawa.ca/15/index.php?option=com_docman&task=doc_download&gid=2805), retrieved 15 October 2017.

149 Government of the Netherlands and the Government of Mongolia, Agreement on encouragement and Reciprocal Protection of Investments between the Kingdom of the Netherlands and Mongolia, article 5, no date, <http://investmentpolicyhub.unctad.org/Download/TreatyFile/2020>, retrieved 15 October 2017.



payments made with regard to the investment (including dividends and interest payments);<sup>150</sup> and that investors have the right to submit any legal dispute over a violation of the treaty by either state to the International Centre for Settlement of Investment Disputes (ICSID).<sup>151</sup>

Turquoise Hill subsidiary Movele – arguably the real investor in Oyu Tolgoi – is registered in Luxembourg, a country that does not have a BIT with Mongolia.<sup>152</sup> Therefore, using a Dutch mailbox company as a conduit for their investment in Mongolia allows Turquoise Hill Resources and Rio Tinto to make undue use of the investment protection provided by the BIT between the Netherlands and Mongolia. Should the GoM want to end the repeating cycle of unrewarding conflict with Rio Tinto over the uneven distribution of wealth from Oyu Tolgoi and take back control of the mine, it would find itself in arbitration before the ICSID trying to explain why it violated the treaty. In such investment dispute cases, rulings in favour of the company can deprive poor countries of much-needed public finance, limiting states' ability to safeguard their people's health and environment.<sup>153</sup> Thus, this corporate structure – existing solely on paper – protects Rio Tinto's investment and at the same time limits the measures open to the GoM for increasing its revenue from the mine.

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150 Government of the Netherlands and the Government of Mongolia, Agreement on encouragement and Reciprocal Protection of Investments between the Kingdom of the Netherlands and Mongolia, article 4, no date, <http://investmentpolicyhub.unctad.org/Download/TreatyFile/2020>, retrieved 15 October 2017.

151 Government of the Netherlands and the Government of Mongolia, Agreement on encouragement and Reciprocal Protection of Investments between the Kingdom of the Netherlands and Mongolia, article 8, no date, <http://investmentpolicyhub.unctad.org/Download/TreatyFile/2020>, retrieved 15 October 2017.

152 Investment Policy Hub, Mongolia: Bilateral Investment Treaties (BITs), no date, <http://investmentpolicyhub.unctad.org/IIA/CountryBits/139>, retrieved 15 October 2017.

153 Both Ends, Milieudefensie, SOMO and TNI, 50 jaar ISDS, 13 January 2018, <https://www.somo.nl/nl/50-jaar-isds-een-mondiaal-machtmiddel-voor-multinationals/>, retrieved 20 January 2018.

## 6 Conclusion

The Oyu Tolgoi copper and gold mining project is the largest investment ever made in Mongolia. At its outset, grand promises were made by Oyu Tolgoi LLC's president about how more than half of the mine's output would go to the Mongolian state, and how the project would "benefit all Mongolians, including future generations".<sup>154</sup> Instead, Rio Tinto has used its position of power in negotiations to receive far-reaching concessions from the Mongolian government to maximise profits made from the Oyu Tolgoi mine, while using international tax avoidance structures to minimise their costs. So far, the wealth of the mine appears to have filled primarily the coffers of Rio Tinto and its fellow investors.

The corporate and financial structure of the Oyu Tolgoi mine is designed to facilitate this process. The ownership of the Oyu Tolgoi mine is shared between the Mongolian state-owned Erdenes Oyu Tolgoi (34 per cent) and Turquoise Hill Resources (66 per cent), a company that is majority owned by Rio Tinto. Turquoise Hill Resources finances the mine using loans routed through a tax avoidance scheme. Erdenes has borrowed its share (34 per cent) of finance needed for the mine from Turquoise Hill Resources. The Oyu Tolgoi Investment Agreement specifies that the Mongolian Government will start to receive profits from the Oyu Tolgoi mine only after these loans have been repaid in full. To this day, this does not appear to have happened. On 1 June 2017, roughly four years after Oyu Tolgoi went into production, the balance of outstanding loan payments shows that the GoM still owes Turquoise Hill Resources some US\$ 1.1 billion.

The Mongolian government's repeated attempts to increase its share of revenue from the mine in negotiations about the Oyu Tolgoi project have met with limited success. This was the case with the windfall tax the GoM introduced in 2006 to increase its tax revenue from extractive industries, and which it was then forced to rescind under pressure from Oyu Tolgoi's investors. It happened again in 2012, when the GoM attempted to renegotiate the Oyu Tolgoi Investment Agreement. The conflict ended in 2015 when the government caved in to pressure from Rio Tinto – which had meanwhile fired 1,700 people and was delaying the planned expansion of Oyu Tolgoi – and accepted that the company would only pay half of the previously demanded taxes.

In 2013, the Mongolian Government acted on a report by the IMF and cancelled its tax treaties with the Netherlands and Luxembourg (instead of the advised renegotiation, which would have taken many years to complete). This was in part a strategy for tackling Rio Tinto's tax avoidance. However, a Rio Tinto spokesman explained that this would not increase the company's tax obligation, as taxes had been "stabilised" in the Oyu Tolgoi Investment Agreement. By agreeing to stabilise – or freeze – tax benefits enshrined in tax treaties at the 2009 level, the Mongolian Government effectively gave up its sovereign right to set its taxes according to the country's needs.

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154 Oyu Tolgoi, All Mongolians Will Benefit From Oyu Tolgoi Says CEO, 2011, <http://ot.mn/s-643/>, retrieved on 9-1-2018

Rio Tinto made use of a tax avoidance scheme involving the Netherlands and Luxembourg, two of the world's biggest tax havens.<sup>155</sup> Over US\$ 6 billion was moved to a mailbox company in Luxembourg, which subsequently financed Oyu Tolgoi with both direct and indirect loans via a mailbox company in the Netherlands. Using mailbox companies to unduly gain tax treaty benefits (provided by the Netherlands and Luxembourg in this case) amounts to treaty abuse.

The Council of the European Union (EU) recently published a list of non-cooperative tax jurisdictions, or tax havens. Luxembourg and the Netherlands do not appear on this list, while Mongolia does.<sup>156</sup> Although Mongolia is generally not known as a tax haven, the country was included in the list for not cooperating with the EU in tax matters. This list shows how the EU applies different standards to its member states in comparison with how it treats third countries. While the EU is currently undertaking commendable efforts to tackle tax avoidance, this effort is being hampered by its failure to address the fact that several of its own member states (including the Netherlands, Luxembourg and Ireland) are among the world's most prominent tax havens.<sup>157</sup> It seems probable that Rio Tinto received favourable tax rulings both in the Netherlands and Luxembourg, providing the company with advance confirmation that its tax avoidance scheme would be accepted by both countries' relevant tax authorities. This has led to an absurd situation: Mongolia is on the EU's tax haven list, yet the country suffers from the tax avoidance facilitated by EU member states that are not on the list.

The Dutch government has allowed Rio Tinto to abuse the treaties and fiscal facilities offered by the Netherlands by enabling it to easily set up a subsidiary. This subsidiary is bound by so-called substance requirements, which are aimed at ensuring that legal entities in the Netherlands have real economic substance. The fact that a company without employees, and with billions of dollars in incoming and outgoing loans, can continue this practice over several years shows that these requirements are lacking. Both Dutch subsidiaries involved in the Oyu Tolgoi project report having zero employees, and arguably undertake no real economic activity. The fact that these companies are allowed to make use of Dutch investment and double taxation treaties is a classic illustration of treaty shopping. The registration of one of these Dutch subsidiaries as a cooperative has possibly allowed Rio Tinto to avoid Dutch withholding taxes on dividends, and the use of Dutch mailbox subsidiaries may allow the company to avoid future tax on capital gains if it sells Oyu Tolgoi. Furthermore, the ease with which companies can set up mailbox companies in the Netherlands also facilitates illegitimate claims to benefits under the Netherlands' bilateral investment treaties. The Dutch Government should therefore review its substance requirements, and implement safeguards against treaty abuse.

The Luxembourg tax authorities have allowed Rio Tinto to apply massive deductions on the company's taxable profit, or to otherwise lower tax obligations in Luxembourg. By doing so, the Luxembourg

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155 Oxfam International, Blacklist or whitewash? What a real EU blacklist of tax havens should look like, 27 November 2017, <https://www.oxfam.org/en/research/blacklist-or-whitewash-what-real-eu-blacklist-tax-havens-should-look>, retrieved on 8 December 2017.

156 Council of the European Union, The EU list of non-cooperative jurisdictions for tax purposes, 5 December 2017, <http://www.consilium.europa.eu/media/31945/st15429en17.pdf>, retrieved 6 December 2017.

157 Oxfam International, Blacklist or whitewash? What a real EU blacklist of tax havens should look like, 27 November 2017, <https://www.oxfam.org/en/research/blacklist-or-whitewash-what-real-eu-blacklist-tax-havens-should-look>, retrieved on 8 December 2017.

Government provides incentives for multinational corporations to shift their profits to Luxembourg and avoid paying taxes where they should (arguably in Canada in the case of Oyu Tolgoi).

By making use of lower withholding tax rates laid down in tax treaties even after they were cancelled – specifically for the reason that they facilitated tax avoidance – Rio Tinto has been able to illegitimately lower its Mongolian tax obligation by US\$ 232 million. Both treaties allowed for a decrease from 20 per cent to 10 per cent of the withholding tax rate levied on interest payments going from Oyu Tolgoi to Rio Tinto’s mailbox subsidiaries in the Netherlands and Luxembourg. And as previously described, after the Mongolian Government backed down in its conflict with Rio Tinto in 2015, this withholding tax rate was reduced further to 6.6 per cent, retroactively and without a legitimate rationale. This is punitive, given the current austerity measures implemented in Mongolia. For example, this income could have allowed the Mongolian Government to almost double its spending on education in the period between 2013 and 2015.

Rio Tinto has managed to avoid paying approximately US\$ 559 million in Canadian corporate income taxes over a seven-year period by using a mailbox company with zero employees in Luxembourg to finance its Oyu Tolgoi operations. In Luxembourg, the company has paid only US\$ 89 million in taxes, against an average effective tax rate of 4.19 per cent, meaning that this tax avoidance scheme has allowed the company to avoid US\$ 470 million net in taxes. Ultimately, Rio Tinto managed not to pay millions of dollars in legitimate Mongolian and Canadian taxes during phase 1 of its Oyu Tolgoi operations. The massive expansion of the mine currently underway (phase 2), developed with a US\$ 4.4 billion public finance debt package, raises urgent questions about the extent to which public money will be flowing through tax avoidance structures.

Rio Tinto’s success in making the Government of Mongolia accept its terms for the Oyu Tolgoi investment has resulted in investments through interest-bearing loans and the mine’s profits being taxed against a very low rate in Luxembourg, instead of in Mongolia and Canada. This has left the Government of Mongolia empty-handed, as income is withheld while loans are being repaid. The process and content of the Investment Agreement between the corporate owners of Oyu Tolgoi on the one hand, and the GoM on the other, can be characterised as abusive. The Government of Mongolia has failed to provide information on the agreements and financial statements of the operating companies to the people of Mongolia, leading to a lack of public scrutiny regarding the country’s regulation of foreign direct investment and the potential benefits thereof.

Another way to increase public scrutiny of tax avoidance schemes like the one detailed in this report would be Public Country-by-Country-Reporting (CbCR).<sup>158</sup> Such Public CbCR requires companies to report their profits and taxes owed per country they operate in, which would have made it easier to identify the tax avoidance scheme employed in the Oyu Tolgoi case. Rio Tinto does publish a Taxes Paid report annually<sup>159</sup>, but those reports fail to provide information on the profit Rio Tinto makes in each country it is present in, which makes it impossible to gauge the value of the taxes they paid. Furthermore, the 2016 Taxes Paid report fails to mention the existence of Movele Sarl

158 European Commission, Public country-by-country reporting, no date, [https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/public-country-country-reporting\\_en](https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/public-country-country-reporting_en), retrieved 22 January 2018.

159 Rio Tinto, Taxes paid, no date, <http://www.riotinto.com/investors/taxes-paid-22105.aspx>, retrieved 22 January 2018.

in Luxembourg, although to be useful as a Public CbCR report, it should.<sup>160</sup> If Rio Tinto or Turquoise Hill Resources were required to publish an annual Public CbCR report listing the tax obligations and profits of all their subsidiaries per jurisdiction, the Oyu Tolgoi tax avoidance scheme may have become public knowledge much earlier.

The scale of Oyu Tolgoi, its finite mineral deposit and the enormous social-ecological impact demand urgent public attention and debate on the desirability of allowing large-scale mineral exploitation under such disadvantageous conditions. The repeated lowering of the withholding tax has significantly decreased any income the GoM can expect to receive from the mine, while the interest paid on the loans to Oyu Tolgoi will likely limit the mine's profitability and any dividends Mongolia can expect to receive. Consequently, a likely future scenario for Oyu Tolgoi involves most of the company's profits leaving Mongolia in the form of interest payments, with the Mongolian Government receiving minimal (if any) dividend payments or corporate income taxes. Meanwhile, the country's mineral wealth is being extracted for the benefit of foreign investors. Within the current context, it seems unlikely that the Mongolian people will benefit much from the Oyu Tolgoi mine.

The fact that the Mongolian Government has agreed to this arrangement shows the depth of the problem. It is impossible to determine whether the GoM's decision making has been distorted due to the country's weak economic position, incompetent governance practices, or other factors. However, it is clear that the Mongolian Government played an important role by accepting the creation of the current system through which the country is being exploited, and that the Mongolian State and its people need to ensure that this system is overturned.

#### **Box 4 Rio Tinto's response to this report**

In their response to this report,<sup>161</sup> Rio Tinto and Turquoise Hill Resources state that their overall financial impact on Mongolia has been positive due to job creation, mining royalty payments, and VAT payments. These payments, although positive, are no substitute for legitimate corporate income tax payments, which are needed to finance Mongolia's government and to fuel its growth. As such, they do not excuse Rio Tinto's tax avoidance, nor the way it has pressured the Mongolian Government into the current abusive Investment Agreement that deprives the country of massive amounts of legitimate tax revenue.

The companies also argue that the Investment Agreement and tax planning arrangements cannot be characterised as abusive since the Mongolian and Canadian governments both agreed to them. SOMO fundamentally disagrees with this line of reasoning, as governments – and particularly the Mongolian Government in this case – can be pressured into disadvantageous arrangements that harm their people.

160 Rio Tinto, 2016 Taxes paid report, April 2017, [http://www.riotinto.com/documents/RT\\_taxes\\_paid\\_in\\_2016.pdf](http://www.riotinto.com/documents/RT_taxes_paid_in_2016.pdf), retrieved 22 January 2018.

161 Rio Tinto and Turquoise Hill Resources email reply to SOMO's review request, received on 17 January 2018.

#### ◉ Box 4 Rio Tinto's response to this report

The fact that the Mongolian Government agreed to sign the Investment Agreement means that it should review its own practices, but this does not excuse the abusive elements in the Investment Agreement nor the investors that negotiated the deal.

Rio Tinto and Turquoise Hill Resources argue that their Luxembourg and Dutch subsidiaries – which SOMO has deemed to be mailbox companies – have legal economic substance, and that they do not need staff because the finance arrangements they are part of do not require management by employees. SOMO agrees with this assessment, to the extent that the companies likely do have substance legally, with the emphasis on legally. The fact that these companies are able to fulfil legal requirement for having economic substance, and are allowed to operate as separate legal entities within the Netherlands and Luxembourg, making use of all of the treaty benefits these countries have to offer, is precisely the problem with lax substance requirements. Legally speaking, these companies live up to the standards set for them. But when examined critically, a company effectively tending to billions of dollars in loans while having no employees or other real activities in its domicile appears illogical. This shows how substance requirements allow for paper realities that have massive impacts in the real world.

Furthermore, Rio Tinto and Turquoise Hill Resources state the following: *"[Oyu Tolgoi] and its investors are committed to tax transparency. We believe that our tax practices are not only compliant with local laws, international standards and voluntary commitments, but that the [Oyu Tolgoi] operation is substantially contributing to Mongolia's economy and long term development."*

Although it is unclear which international standards and voluntary commitments the companies refer to, the tax practices concerning Oyu Tolgoi arguably violate the OECD's Guidelines for Multinational Enterprises,<sup>162</sup> which are probably the most authoritative international standard and guidance on corporate taxation. Namely, article 11 of the standard states the following: *"It is important that enterprises contribute to the public finances of host countries by making timely payment of their tax liabilities. In particular, enterprises should comply with both the letter and spirit of the tax laws and regulations of the countries in which they operate. Complying with the spirit of the law means discerning and following the intention of the legislature."*<sup>163</sup>

By aggressively minimizing its Mongolian tax obligation and pushing the country's government for an advantageous tax deal, Rio Tinto has arguably violated the spirit of Mongolia's tax law,<sup>164</sup> and its purpose of maintaining a fair and balanced fiscal environment within the country.

162 OECD, Guidelines for Multinational Enterprises, 2011, <http://www.oecd.org/corporate/mne/>, retrieved 6 December 2017.

163 OECD, Guidelines for Multinational Enterprises, page 60, 2011, <http://www.oecd.org/corporate/mne/>, retrieved 6 December 2017.

164 Government of Mongolia, General Law on Taxation, 20 May 2008, <http://www.eisourcebook.org/cms/February%202016/Mongolia%20General%20Law%20on%20Taxation%202008.pdf>, retrieved 6 December 2017.

## 6.1 Recommendations

All states involved in the Oyu Tolgoi case share the responsibility of addressing the tax avoidance and minimisation identified in this report. Furthermore, the recent publication of a tax haven list by the European Commission highlights the role that the EU fails to play in tackling international tax avoidance, particularly in poor countries, and the central role played by EU jurisdictions. Rio Tinto has specific obligations to refrain from aggressive tax planning, to stop using its economic position to put Mongolia under pressure, and to grant tax relief. Its shareholders should hold the company to account.

### The Dutch Government

- is currently re-negotiating a bilateral double taxation agreement with the Government of Mongolia.<sup>165</sup> To ensure mining companies will not abuse this upcoming treaty in the future, and in order to safeguard Mongolia's tax revenues, the Dutch Government should refrain from negotiating a reduction of withholding tax rates for royalty and interest payments.
- should refrain from providing fiscal benefits to Rio Tinto, and should make public any Advance Pricing Agreement or Advance Tax Ruling the company has (or had) with the Dutch revenue authority in order to allow for public scrutiny of its tax effects.
- should introduce effective substance rules and implement the general anti-abuse rule as proposed by the European Commission in its Action Plan against tax fraud.
- should ensure that its fiscal policies do not allow multinational corporations to enjoy double non-taxation, as appears to have happened in the Oyu Tolgoi case, and should refrain from providing tax rulings that allow for double non-taxation.

### The Government of Luxembourg:

- should review what happened with the financing of Oyu Tolgoi. In the case that the Luxembourg tax authorities provided a tax ruling, the government should revise its current ruling practice. More generally, Luxembourg should ensure that its fiscal policies do not allow multinational corporations to enjoy double non-taxation, as appears to have happened in the case of Oyu Tolgoi.

### The Government of Mongolia:

- should refrain from signing investment agreements with foreign investors that have negative impacts on the country's policy space and revenue. Specifically, the Mongolian Government should revise its Investment Agreement with Rio Tinto concerning Oyu Tolgoi if this mine is ever to generate financial benefits for the Mongolian people.
- should revise how it approaches Double Taxation Agreements, and consider the tax losses it will face when signing agreements that allow for a reduction in withholding tax rates. This is specifically relevant with developed countries that are the source of significant FDI and are likely to gain substantially from such rate reductions.

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<sup>165</sup> Eurodad, Tax games: the race to the bottom, note 1037 in the report, <https://www.somo.nl/tax-games-the-race-to-the-bottom/>, retrieved 6 December 2017.

- should provide more transparency on Oyu Tolgoi, for example by publishing Oyu Tolgoi LLC's annual accounts and documentation on the transfer prices against which the company sells its copper and gold. The GoM should make sure that negotiations and deals within the Mongolian mining sector follow the law and safeguard the interests of the Mongolian people, for example by instating an independent supervisory body.
- should consider the scale of Oyu Tolgoi, its finite mineral deposit, and the enormous social-ecological impact that is possibly being exacerbated by climate change induced drought. The GoM should urgently facilitate public debate in order to discuss the desirability of such large-scale exploitation for Mongolia under such disadvantageous conditions.

**The EU:**

- should revise its non-cooperative tax jurisdictions list, and change its methods for compiling this list in order to include EU member states in the analysis when defining tax havens.
- should investigate possible tax rulings between the Netherlands, Luxembourg and any Rio Tinto subsidiaries to review whether these comply with EU state aid rules.

**Rio Tinto:**

- should commit to a joint review and the renegotiation of the Oyu Tolgoi Investment Agreement together with the Government of Mongolia. This would allow for a fairer division of the mine's revenues with the Mongolian state.
- should refrain from avoiding taxes, abandon all tax avoidance schemes it currently employs, and start managing its operations in a fiscally responsible manner.

**Other shareholders of Turquoise Hill Resources:**

- should exert pressure on the company to allow for a more even distribution of Oyu Tolgoi's revenues between the company and the Mongolian state. A first step in this process would be to revise the Oyu Tolgoi Investment Agreement.



## Mining taxes

The case of Oyu Tolgoi and profitable tax avoidance  
by Rio Tinto in Mongolia

The Oyu Tolgoi mine, located in the Southern Gobi region, is Mongolia's flagship copper and gold mine. Considered to be one of the world's larger copper and gold deposits, it is financed by the largest public finance deal in the history of the mining and metals industry. The region is also home to nomadic herders, and houses a large number of endangered animal and plant species. The mine is ultimately owned and operated by Rio Tinto, which controls it through an ownership structure consisting of multiple subsidiaries in tax havens. The Government of Mongolia owns a minority 34% stake. The Oyu Tolgoi mine and its operator Rio Tinto play a central role in Mongolia's natural resource policies. The Investment Agreement providing Rio Tinto with a favourable fiscal position protected from legislative changes has inspired repeated calls for greater public control over the country's resources.

This report examines the investment deal is of limited benefit for the Mongolian people but enables Rio Tinto with a tax dodging scheme involving the Netherlands and Luxembourg, two of the world's foremost tax havens. Investments through interest-bearing loans and profits being taxed against a very low rate in Luxembourg, instead of in Mongolia and Canada, has enabled Rio Tinto to avoid tax payments to Canada and Mongolia reaching US\$700 million. The repeated lowering of the withholding tax has significantly decreased any income Mongolia can expect from the mine, while the interest paid on loans limit profitability and any dividends in the near future.

The scale of Oyu Tolgoi, its finite mineral deposit and the enormous social-ecological impact demand urgent public attention and debate on the desirability of allowing large-scale mineral exploitation under such disadvantageous conditions.

