Republic of the Marshall Islands

GUIDANCE AND FREQUENTLY ASKED QUESTIONS ON ECONOMIC SUBSTANCE

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Republic of the Marshall Islands
Guidance and Frequently Asked Questions on Economic Substance

BACKGROUND

The Republic of the Marshall Islands (RMI) Economic Substance Regulations, 2018 (the "ESRs") promulgated by the Registrar of Corporations responsible for non-resident domestic entities (the "Registrar") entered into force on 1 January 2019 and were further amended on 21 February 2019 and 29 August 2019. They are applicable to all "relevant entities" engaged in a "relevant activity." Compliance with the ESRs is required forfinancial periods commencing on or after 1 January 2019, with reporting requirements commencing in 2020 (see Section 12 below for more details on reporting requirements and timelines).

The ESRs are responsive to the Organisation for Economic Co-operation and Development (OECD) and European Union (EU) measures to implement Base Erosion and Profit Shifting (BEPS) and fair taxation standards regarding geographically mobile activities. Substance requirements for geographically mobile activities are being implemented by jurisdictions across the globe to adhere to international standards. These requirements are already being assessed and monitored for over 130 countries, including no or only nominal tax jurisdictions, by the OECD Inclusive Framework on BEPS under its BEPS Action 5.

This Guidance and Frequently Asked Questions on Economic Substance provides additional detail and practical information for understanding and complying with economic substance requirements and should be read in conjunction with the ESRs. As global standards continue to evolve, the ESRs and this guidance document will be updated accordingly.

FREQUENTLY ASKED QUESTIONS AND GUIDANCE

1. Which entities are required to have economic substance?

All non-resident domestic entities (NRDEs) and foreign maritime entities (FMEs) which meet the definition of a "relevant entity" and which derive income from a "relevant activity" are within the scope of the economic substance requirements with respect to the relevant activity.

2. What is a "relevant entity?"

If an NRDE which is tax resident in the RMI is a relevant entity. FMEs that are centrally managed and controlled in the Republic are relevant entities.

An NRDE will be considered a non-relevant entity, and outside of the scope of the ESRs, if the entity can provide objective evidence to the Registrar that it is tax resident in a jurisdiction outside of the RMI. Similarly, where an FME is centrally managed and controlled from within the Republic, it will be considered a non-relevant entity if the FME can provide objective evidence of tax residency outside of the Republic.

3. What is considered sufficient objective evidence to show tax residency in another jurisdiction outside of the RMI?

The Registrar may regard an entity as tax resident outside the RMI if the entity is subject to the tax regime of another jurisdiction by reason of its domicile, residence, or any other criteria of a similar nature.

The Registrar will require any entity claiming to be tax resident outside the RMI to produce satisfactory evidence such as a tax identification number, tax residence certificate, assessment or payment of a tax liability, or other proof the entity is subject to the tax regime of another jurisdiction. A disregarded entity for United States (US) income tax purposes (or other similarly treated entities in other jurisdictions) may produce as objective evidence a signed statement under penalty of perjury from an external tax advisor or "C" level officer stating that all of that entity's income has been included on the corporate tax return of the parent company.

4. What is a "relevant activity?"

Relevant activities are limited to: (a) distribution and service center business; (b) financing and leasing business; (c) fund management business; (d) headquarters business; (e) holding company business; (f) intellectual property business; (g) shipping business; (h) banking business; and (i) insurance business.

Each relevant activity is further defined in Section 2 of the ESRs.

Note: Although banking and insurance business are listed as relevant activities, the RMI Associations Law prohibits all NRDEs and FMEs from carrying on the business of banking or granting policies of insurance or assuming insurance risks.

5. Does compliance with the ESRs constitute "doing business in the RMI" or create a resident domestic entity?

An NRDE or FME does not become a resident domestic entity as defined in the Associations Law merely by complying with the requirements of the ESRs.

"Doing business in the Republic," as defined in § 2(q) of the RMI Associations Law, means:

> the corporation, partnership, trust, unincorporated association, or other entity is carrying on business or conducting transactions in the RMI. A non-resident corporation, partnership, trust, unincorporated association, or other entity shall not be deemed to be doing business in the RMI

merely because it engages in one or more or all of the following activities:

(i) maintains an administrative, management, executive, billing, or statutory office in the RMI;

(ii) has officers or directors who are residents or citizens of the RMI; provided, however, that any income derived therefrom and received by such resident officers or directors shall be deemed domestic income;

(iii) maintains bank accounts or deposits, or borrows from licensed financial institutions carrying on business within the RMI;

(iv) makes or maintains professional contact with or uses the services of attorneys, accountants, bookkeepers, trust companies, administration companies, investment advisors, or other similar persons carrying on business within the RMI;

(v) prepares or maintains books and records of accounts, minutes, and share registries within the RMI;

(vi) holds meetings of its directors, shareholders, partnership, or members within the RMI;

(vii) holds a lease or rental of property in the RMI, solely for the conduct of any activity specified in this subsection;

(viii) maintains an office in the RMI, solely for the conduct of any activities allowed in this subsection;

(ix) holds or owns shares, debt obligations, or other securities in a corporation, partnership, trust, unincorporated association, or other entity incorporated or organized in the RMI;

(x) maintains a registered business agent as required by any applicable provision of the laws of the RMI; and

(xi) secures and maintains registry in the RMI of any vessel, or conducts other activities in the RMI, solely related to the operation, chartering, or disposition of any vessel outside of the RMI.

In no event, including claiming tax residency status or obtaining an Employer Identification Number (EIN) in the RMI, will a "non-resident corporation, partnership, trust, unincorporated association or other entity" as defined in § 2(k) of the Business Corporations Act be construed to be a "resident domestic corporation" as defined in § 2(l) of the Business Corporations Act, a "resident domestic partnership" as defined in § 1(18) of the Revised Partnership Act, a "resident domestic limited partnership" as defined in § 1(18) of the Limited Partnership Act, or a "resident domestic limited liability company" as defined in § 2(19) of the Limited Liability Company Act.

6. Shipping Business

a. What constitutes shipping business?

Section 2(u) of the ESRs define "shipping business" as:

> the operation of ships in international traffic for income from the transport of passengers or cargo and includes any of the following activities where the relevant activity is directly connected with, or ancillary to, such operation:
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> i. the rental on a charter basis of a ship;
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> ii. the sale of tickets or similar documents and the provision of services connected with the sale of tickets or similar documents, either for the enterprise itself or any other enterprise;
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> iii. the use, maintenance, or rental of containers (including trailers and related equipment for the transport of containers) used for the transport of goods or merchandise; or
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> iv. the management of the crew of a ship;
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> v. the registration of a ship;
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> vi. the recording of a financial instrument or lien in relation to a ship;
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> vii. the ownership of a ship;
>
> viii. the financing of a ship;
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> ix. the obtaining of statutory certificates for a ship;
>
> x. the surveying of a ship; or
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> xi. the provision of services related to the foregoing.

b. How will the Registrar determine whether entities engaged in shipping business meet the economic substance test?

In determining economic substance in the context of shipping business, the Registrar recognizes that significant core income generating activities (CIGA) within shipping are performed in transit outside of the RMI, and that the value creation attributable to the CIGA that occur from a fixed location is more limited than for other types of regimes for mobile business income. This means that a relevant entity engaged in shipping business may satisfy the economic substance test by the operation of the vessel in international traffic including the management of the crew aboard the vessel, maintenance of the vessel, and overseeing voyages and activities related thereto.

The determination will further consider whether the relevant entity handles all obligations under the RMI Associations Law and Maritime Act 1990, including compliance with applicable International

Maritime Organisation and International Labour Organisation regulations, customs, and manning requirements and whether all financial obligations to the RMI have been fulfilled.

c. Is the ownership, operation, or chartering of a private yacht considered shipping business?

Private yachts, as defined in § 112 of the RMI Maritime Act, are engaged on private voyages or excursions and are not engaged in trade by transporting merchandise or carrying passengers for reward or remuneration (other than as a contribution to the actual cost of the yacht or its operation for the period of the voyage or excursion). Thus, the owning, operating, or chartering of a private yacht, does not fall within the definition of shipping business as a relevant activity and is not subject to the economic substance test. Similarly, the charter by demise or bareboat charter of a private yacht for the pleasure or recreational use by the charterer or others does not constitute shipping business.

7. What if a relevant entity performs a relevant activity only as a portion of its business? What if the entity does not derive income from the relevant activity?

For each financial period in which a relevant entity derives income from a relevant activity, it must have economic substance in the RMI only in relation to the portion of its business which is a relevant activity. If no income is derived from a relevant activity or no relevant activity is performed, then the entity is not required to have economic substance with regard to that portion of its business for that financial period.

However, the relevant entity will still be required to meet any applicable reporting obligations under the ESRs, such as submitting the annual report to the Registrar.

8. How would a relevant entity carrying out a relevant activity meet the economic substance test?

A relevant entity may meet the three-part economic substance test by: being directed and managed in the RMI in relation to that relevant activity; having an adequate number of employees, an adequate physical presence, and adequate expenditure in the RMI; and by carrying out CIGA in the RMI.

(a) *Directed and managed test.* The directed and managed test requires that the relevant activity or activities (not necessarily the NRDE or the FME itself) be directed and managed from the RMI. This requires board meetings to be held and attended by a quorum of persons physically present in the RMI with adequate frequency, considering the nature of the relevant activity and its importance to the overall business of the NRDE or FME. What constitutes an adequate frequency of meetings in the RMI will be dependent on the individual circumstances and facts of the relevant entity and its relevant activities. It is incumbent upon the governing body to make the determination in good faith with regard to whether there is an adequate frequency of such meetings.

The minutes of relevant governing body meetings and appropriate records should be kept in the RMI. This may be satisfied by recording such meeting minutes and other records with the Registered Agent.

(b) *Adequate employees and presence test.* The determination of what is an adequate number of employees, physical presence, and expenditure will be determined based on the level of relevant activity carried out in the RMI.

(c) *CIGA test.* CIGA are the activities of central importance to the relevant entity in terms of generating income of the entity which, if carried out by relevant entity in respect of a relevant activity, must be carried out in the RMI.

9. May a third party perform the CIGA on behalf of the relevant entity?

A relevant entity satisfies the economic substance test with respect to Section 4(2)(c) of the ESRs if another person conducts the CIGA in relation to the relevant activity so long as:

(a) the relevant entity is able to monitor and control the CIGA conducted by another person;

(b) the CIGA are carried out in the RMI; and

(c) the economic substance of the other person will not be counted multiple times by multiple relevant entities when evidencing their own substance in the RMI.

The ESRs do not prohibit the use of service providers, other entities within the relevant entity's group of companies, or other third parties to perform all or part of an activity in the RMI.

The relevant entity must be able to monitor and control the delegated activities and demonstrate it maintains adequate supervision of delegated activities. The resources of the service provider will be taken into consideration when determining if the test in Section 4(2)(b) of the ESRs is met. The resources should be sufficient to prevent double-counting of services provided to more than one relevant entity.

10. Do pure equity holding companies have a lower threshold to show economic substance?

Yes, pure equity holding companies may satisfy the economic substance test by compliance with all applicable filing requirements of the Business Corporations Act, Revised Partnership Act, Limited Partnership Act, or Limited Liability Companies Act, including the payment of all fees.

Additionally, a pure equity holding company must have adequate human resources and premises in the RMI for holding and managing participations in other entities. "Adequate" will be determined based on the circumstances of each pure equity holding company. However, a pure equity holding company may be able to satisfy these reduced substance requirements by maintaining a registered agent in the RMI in accordance with the Associations Law. A pure equity holding company is not required to be directed and managed in the RMI.

11. What are the heightened requirements for relevant entities engaged in high risk intellectual property (IP) business?

Relevant entities engaged in the business of high risk IP must be able to demonstrate that a high degree of control over the development, exploitation, maintenance, enhancement, and protection of the asset is, and historically has been, exercised by full time highly skilled employees that permanently reside and perform their core activities within the RMI.

Section 2(i) of the ESRs define "high risk IP business" as:

> an IP business carried on by:
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> i. an entity that:
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> 1. did not create the IP in an IP asset that it holds for the purposes of its business;
> 2. acquired the IP asset:
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> a. from an entity in the same Group; or
> b. in consideration for funding research and development by another person situated in a country or territory other than the RMI; and
>
> 3. licenses the IP asset to one or more entities in the same Group or otherwise generates income from the asset in consequence of activities (such as facilitating sale agreements) performed by entities in thesame Group; or
>
> ii. an entity that does not carry out the core income-generating activities specified in Section 5(f)(i) or (ii) of the ESRs in the RMI.

12. When do entities need to begin reporting to the Registrar?

Beginning in mid-2020, all NRDEs and FMEs will need to submit an Economic Substance Declaration to the Registrar. The reporting period will open on the annual anniversary date of the NRDE or FME and the Economic Substance Declaration must be made within twelve months thereafter. For newly formed entities, the reporting period will open on their first anniversary date. All NRDEs and FMEs must report whether they are a relevant entity and, if so, whether they have derived income from a relevant activity.

Additional reporting requirements will apply to NRDEs and FMEs determined to be relevant entities engaged in a relevant activity. At a minimum, each relevant entity must prepare and file the following information for the relevant financial period from which it derives income from a relevant activity:

(a) business type (to identify the type of mobile activity);

(b) amount and type (e.g., rents, royalties, dividends, sales, services) of gross income;

(c) amount and type of expenses and assets;

(d) premises;

(e) number of employees, including the number of full-time employees; and

(f) information showing that it has conducted relevant core income-generating activities in the RMI.

All reporting will be done through a dedicated secure web portal which is being developed by the Registrar.

Reporting timelines are subject to change at the discretion of the Registrar.