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OUTCOME OF PROCEEDINGS

From:	General Secretariat of the Council
To:	Code of Conduct Group
Subject:	The EU list of non-cooperative jurisdictions for tax purposes - Marshall Islands: final legislation and assessment under criterion 2.2

A/ FINAL LEGISLATION:

The Economic Substance Regulations, 2018 were approved on 21 December 2018 by the Cabinet and signed by the President on the same date for entry into force on 1 January 2019.

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The Marshall Islands have adopted amendments to the Economic Substance Regulations, 2018 on 21 February 2019.

On 15 August 2019, the Cabinet of the Marshall Islands adopted a new amendment to the Economic Substance Regulation:

(1) *Non-relevant entities. In the event an entity is not deemed to be a relevant entity because its business is centrally managed and controlled outside the Republic and it is tax resident outside the Republic, the Registrar* ***shall obtain objective evidence of tax residence outside of the Republic[1] from each non-relevant entity and*** *shall provide any relevant information or evidence provided to the Registrar which relates to the entity to:*

(a) *the competent authority of the European Union Member State in which the parent company, ultimate parent company, and ultimate beneficial owner of the entity resides; and*

(b) *the competent authority of the European Union Member State in which the entity claims to be tax resident.*

These amendments became part of the pre-existing Economic Substance Regulations, 2018 that remained applicable as of 1 January 2019.

The final legislation is available at the following link:

https://www.register-iri.com/wp-content/uploads/Economic-Substance-Regulations-2018-courtesy-copy-published-by-the-Registrar-of-Corporations-through-29-August-2019-amendments.pdf

[1] **The Registrar may regard an entity as tax resident outside the Republic 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 Republic to produce satisfactory evidence to substantiate the same, 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.**

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B/ FINAL ASSESSMENT:

The dialogue with the Marshall Islands was rather limited until end 2018 as no draft legislation had been shared for feedback by the COCG and technical assistance by the Commission services until the adoption of the final text on substance requirements in December 2018. However, since the final legislation was shared, the dialogue has been constructive. The Commission Services reported regularly to Member States on the progress of the discussion with the Marshall Islands.

The following assessment highlights the remaining issues identified and still pending at the beginning of 2019:

1 – Identification of the relevant activities and included entities

1.1 – On included entities

Section 2(s) of the Economic Substance Regulations, 2018 defined relevant entities as being non-resident domestic corporations, partnerships, limited partnerships or limited liability companies that are tax resident of the Marshall Islands.

From the replies of the Marshall Islands to the 2.2 questionnaire, it appeared that the following entities exist under Marshall Islands legislation:

- Resident and non-resident domestic corporations (resident corporations are entities doing business in the Marshall Islands while non-resident domestic entities are entities not doing business in the Marshall Islands);
- Partnerships;
- Limited Partnerships;
- Limited Liability Companies;
- Authorised foreign entities;
- Foreign maritime entities.

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From the wording of the regulation, it appeared that resident domestic corporations (entities doing business in the Marshall Islands), authorised foreign entities and foreign maritime entities would not be included in the scope of substance requirements.

As a result, the Commission services reported to The Marshall Islands in February 2019 that Member States could not provide a positive assessment in the absence of further clarification on the entities included in the scope of substance requirements.

The Commission services have especially enquired about the exclusion of resident domestic entities, authorised foreign entities and foreign maritime entities.

Although the Marshall Islands consider that domestic resident entities and foreign authorised entities are already required to have substance in the jurisdiction under the Associations Law and are subject to a 3% tax on their gross revenue, they amended their legislation.

According to new Section 2(s), a relevant entity means:

i) A corporation, partnership, limited partnership, or limited liability company, other than a resident domestic corporation, partnerships, LP or LLC, that is incorporated or formed under the Business Corporations Act, Revised Partnership Act, Limited Partnership Act or Limited Liability Company Act, unless its business is centrally managed and controlled outside the Republic and it is tax resident outside the Republic; or

ii) A corporation, partnership, limited partnership, limited liability company, or other entity incorporated or formed outside of the Republic (a “foreign entity”) registered under the Business Corporations Act, Revised Partnership Act, Limited Partnership Act, or Limited Liability Company Act, including a foreign maritime entity, whose business is centrally managed and controlled in the Republic, unless the foreign entity is tax resident outside the Republic;

From the explanation provided by the Marshall Islands together with the Amended Regulation, this definition should capture foreign corporations, partnerships, limited partnerships and LLC, including foreign maritime entities that are centrally managed and controlled in the Marshall Islands unless they are tax resident in another jurisdiction.

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Foreign authorised entities[2] as well as foreign maritime entities[3] will be included. However, resident domestic entities are still excluded from the scope of substance requirements. Other jurisdictions have introduced similar exclusions for domestic entities. There is no requirement for local ownership in the Marshall Islands legislation to be considered as a domestic entity. Nevertheless, those entities are required to do business in the Marshall Islands[4] and file an annual report with the Registrar of corporations stating their principle place of business in the Marshall Islands, any land owned or leased in the Marshall Islands and the business being conducted in the Marshall Islands. They have to obtain a business licence[5] as well as an employer identification number[6]. They are also subject to a 3% tax on the amount of gross revenues earned per year by the company in excess of $10,000. Gross income includes all gross receipts. Finally, the Marshall Islands have provided data on those entities. There are currently 353 resident domestic corporations, 12 resident domestic LLCs, 1 resident domestic partnership and 0 resident domestic limited partnership.

Conclusion:

This issue is settled. Considering the data provided by the Marshall Islands and the existing regulatory framework for domestic resident entities, the risk of profit shifting is considered as limited. The number of domestic resident entities registered in the jurisdiction in the coming years will be included in the general monitoring.

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[2] There are currently 77 foreign authorised entities.

[3] There are currently 1421 foreign maritime entities.

[4] This is being defined under the Associations law as “carrying on business or conducting transactions in the Republic”.

[5] To obtain a business licence, a resident domestic entity must provide: the business name, type of business, local business location, a statement that the business will comply with local ordinances for maintaining accurate financial records and will make such records available to relevant government authorities, and a commitment to pay all taxes and fees to the Marshall Islands tax authorities.

[6] To obtain an employer identification number, a resident domestic entity must provide: the business name, business address, type of business, business description, affiliated companies, names of owners and officers, number of part-time and full-time employees, annual gross revenue, and other information relevant to the business to the Marshall Islands Social Security Administration Tax Compliance Department -Corporate Services.

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1.2 – On relevant activities

The Marshall Islands have included, as relevant activities in its Economic Substance Regulations, 2018:

- Distribution and service center business;
- Financing and leasing business;
- Fund management business;
- Headquarters business;
- Holding company business;
- IP business;
- Shipping business.

The Marshall Islands had expressly excluded banking business and insurance business, as the relevant entities covered by the Economic Substance Regulations, 2018 were not allowed to carry out insurance and banking business.

This exclusion had to be viewed in relation to the scope of included entities that does not include resident domestic corporations as well as authorised foreign entities and foreign maritime entities.

As a result, the Commission services reported to the Marshall Islands in February 2019 that Member States could not provide a positive assessment because it could not be ascertained whether the exclusion of banking and insurance business was relevant for the Marshall Islands.

Considering the new definition of relevant entities that may include foreign authorised entities, the Marshall Islands have revised Section 3 of the Regulation to include banking and insurance business.

Conclusion:

This issue is settled.

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2 - Imposition of substance requirements

2.1 – Tax residence

The Economic Substance Regulations, 2018 only applied to relevant entities that are tax resident of the Marshall Islands. The regulation did not define tax residence in the Marshall Islands, which makes it difficult to assess whether cases of exclusion based on tax residence are properly contained by existing legislation.

In particular, it was difficult to understand whether there could be a case in which a non-resident domestic corporation would be considered tax resident by the Marshall Islands and thus subject to substance requirements.

As a result, the Commission services reported to the Marshall Islands in February 2019 that Member States did not have the information necessary to assess whether the exclusion based on tax residence was properly contained.

Substance requirements did not apply to relevant entities centrally managed and controlled outside the Marshall Islands and that are tax resident outside of the Marshall Islands.

The Commission services have informed the Marshall Islands that Member States accept such exclusion only with appropriate safeguards to avoid circumvention of the substance requirements. This would include:

- Strong evidencing that the other jurisdiction is considering the entity as tax resident for the relevant activity (not only based on the type of registration or a declaration by the entity itself) through the requirement to file tax certificate, tax return and other objective elements of tax residence from the other jurisdiction.
- Spontaneous exchange of information both with the jurisdiction of claimed tax residence and the jurisdiction of the legal and beneficial owner in order to allow cross-checking of information.

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The amended Section 8(4) of the Regulation provided that:

"*In the event an entity is not deemed to be a relevant entity because its business is centrally managed and controlled outside the Republic and it is tax resident outside the Republic, the Registrar shall provide any relevant information or evidence provided to the Registrar which relates to the entity to:*

a) The competent authority of the EU MS in which the parent company, ultimate parent company and ultimate beneficial owner of the entity resides; and

b) *The competent authority of the EU MS in which the entity claims to be tax resident*".

This section was in line with Member States' expectations in respect of exchange of information. However, there was no indication that the authorities will require entities claiming exemption to evidence their tax residence in another jurisdiction through the requirement to file tax certificate, tax return or other objective elements of tax residence from the other jurisdiction. In particular, contrary to other jurisdictions, the Marshall Islands had provided for filing obligations only for the "relevant entities" which, by definition, excluded non-resident entities.

There are 45,000 active non-resident domestic entities registered in the Marshall Islands[7]. Considering those are the ones doing their business outside the Marshall Islands, they entail a higher risk of claiming to be tax resident in another jurisdiction. Therefore, it was necessary that the Marshall Islands require from them to evidence their tax residence in another jurisdiction.

The amendment adopted in August 2019 uses a similar wording to wording used by other 2.2 jurisdictions and requires entities claiming to be tax resident in another jurisdiction to provide objective evidence of such tax residence through documents issued by the other jurisdiction.

<u>Conclusion:</u>

This issue is settled.

[7] Data provided by the Marshall Islands in their reply to the 2.2 questionnaire, based on 2016 information.

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2.2 – Outsourcing safeguards

Section 4(4) of the Economic Substance Regulations, 2018 provided for the possibility to outsource core-income generating activities to another person provided that the relevant entity is able to monitor and control the carrying out of the core income generating activity by the other person.

From the Scoping Paper, it is clear that outsourcing should only be allowed in the jurisdiction but this was not specified in the Marshall Islands regulation.

Moreover, there was no reference to the prohibition of double counting of the resources of the service provider.

As a result, the Commission services reported to the Marshall Islands in February 2019 that Member States assessed negatively the outsourcing safeguards, as it was not clearly stated that outsourcing of CIGAs was only allowed in the jurisdiction and that double counting of the resources of the service provider was prohibited.

The amended Section 4(4) provides that, in case of outsourcing:

i) The relevant entity should be able to monitor and control from the Marshall Islands, the carrying out of the CIGAs by the service provider;

ii) The CIGAs must be carried out in the Marshall Islands; and

iii) The economic substance of the service provider will not be counted multiple times by multiple relevant entities when evidencing their own substance in the Marshall Islands.

Conclusion:

This issue is settled.

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2.3 – CIGAs in or from within the jurisdiction

Section 5 of the Economic Substance Regulations, 2018 provided that core income generating activities should be carried out in or from within the Republic.

As already discussed in the context of other jurisdictions, the reference to CIGAs being carried out from within the Marshall Islands could have meant that key functions of a relevant activity are controlled from the jurisdiction but could be carried out somewhere else. The Scoping Paper aims at having key functions conducted in the 2.2 jurisdictions and the wording should clearly reflect that.

As a result, the Commission services reported to The Marshall Islands in February 2019 that Member States considered that core income generating activities should be carried out in the Marshall Islands without reference to "from within".

Section 5 of the Regulation was amended in that sense: "*core income generating activities means activities of central importance to a relevant entity in terms of generating income and that are being carried out in the Republic*"

Conclusion:

This issue is settled.

2.4 – Income threshold

Section 4(8) of the Economic Substance Regulations, 2018 provided that a relevant entity is not required to meet the substance test in any financial period for which it has no income in relation to the relevant activity it carries out.

As already discussed about other jurisdictions, the triggering criterion for substance requirements should be the carrying on of a relevant activity and not the recording of income from such activities.

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As a result, the Commission services reported to The Marshall Islands in February 2019 that Member States considered that the triggering criterion for substance requirements should be the carrying on of a relevant activity and not the recording of income from such activities.

Section 4(8) of the regulation provided that a relevant entity is not required to meet the substance test in any financial period for which it has no income in relation to the relevant activity it carries out. This section has been removed from the Amended Regulation.

Conclusion:

This issue is settled.

2.5 – Specific CIGAs for IP

Section 5(f) of the Economic Substance Regulations, 2018 provided the list of CIGAs for IP business.

The first issue was that the regulation did not distinguish between the main CIGAs (R&D / marketing, branding, distribution) and the alternative CIGAs that could be accepted in exceptional cases.

The second issue was that, for the main CIGAs, there was no link made between the type of assets and the CIGAs that are expected to be carried out (for patents, R&D and for non-trade intangible, marketing, branding and distribution).

As a result, the Commission services reported to The Marshall Islands in February 2019 a negative assessment of the specific CIGAs for IP activities as the regulation did not distinguish between the main CIGAs (R&D / marketing, branding, distribution) and the alternative CIGAs that can be accepted in exceptional cases.

In addition, there was no link between the type of assets and the CIGAs expected to be carried out (for patents, R&D and for non-trade intangible, marketing, branding and distribution).

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The Marshall Islands have redrafted Section 5(f):

- to clearly state that the other alternative CIGAs can only be taken into account in exceptional cases, except if the relevant entity is a high-risk IP business; and
- to make a link between R&D and patents on one hand and between branding, marketing and distribution on the other hand.

Conclusion:

This issue is settled.

3 – Enforcement and sanction mechanism

3.1 – Filing obligations

Section 6 of the Economic Substance Regulations, 2018 provided for an obligation to file reports, returns and other information reasonably required by the Registrar in order to determine whether the substance test is met. These reports, returns and other information had to be provided in such forms, at such times, and in respect of such financial periods as the Registrar may require.

This section was very unclear as to the exact filing requirements and whether the appropriate information would systematically be filed by relevant entities.

As a result, the Commission services reported to The Marshall Islands in February 2019 a negative assessment of the filing obligations as the regulation was very unclear as to the exact filing requirements and whether the appropriate information would systematically be filed by relevant entities.

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Section 6(1) was redrafted to include minimum filing requirements for relevant entities with the following information:

- business type (to identify the type of mobile activity);
- amount and type (e.g. rents, royalties, dividends, sales, services) of gross income;
- amount and type of expenses and assets;
- premises;
- number of employees, including number of full-time employees; and
- information showing that it has conducted relevant core-income generating activities in the Marshall Islands.

Conclusion:

This issue is settled.

3.2 – Exchange of information

Section 8 of the Economic Substance Regulations, 2018 provided for spontaneous exchange of information in case of non-compliance and high-risk IP scenarios. However, there was no reference to exchange of information in case an entity claims not to be resident in the Marshall Islands.

As a result, the Commission services reported to The Marshall Islands in February 2019 a negative assessment due to the absence of exchange of information in case of an entity claiming to be tax resident in another jurisdiction.

Amended section 8(4) subsequently provided for the spontaneous exchange of information with the jurisdiction of tax residence and the jurisdiction of the legal and beneficial owner.

However, since the Marshall Islands did not specify that entities claiming to be tax resident in another jurisdiction would have to file information evidencing this situation, it remained very unclear what information the Marshall Islands would, in practice, be in a position to exchange with the relevant Member States.

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The amendment adopted in August 2019 provides that the objective evidence required from entities claiming to be tax resident in another jurisdiction will be exchanged spontaneously with the relevant EU Member States.

Conclusion:

This issue is settled.

3.2 – Sanction framework

Section 7 of the Economic Substance Regulations, 2018 provides that when the Registrar determines that a relevant entity has not met the substance test, a notice will be issued stating the reasons for determination, any applicable penalties (not exceeding 50,000$ for each financial period, revocation and dissolution or both) and such other information as may be determined by the Registrar.

The sanction system may not be dissuasive enough. However, that issue will be considered amongst the evaluation of the enforcement of the substance regulation in the upcoming years.

Conclusion:

This issue is settled. The efficient enforcement of the substance regulation will be subject to monitoring over the coming years.

Conclusion

Marshall Islands has implemented its commitment to introduce substance requirements under criterion 2.2.

ANNEX 1: assessment by COCG experts in 2017

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ANNEX 1: ASSESSMENT BY COCG EXPERTS IN 2017

<table>
<tr><th></th><th>1a</th><th>1b</th><th>2a</th><th>2b</th><th>3</th><th>4</th><th>5</th></tr>
<tr><td>Marshall Islands</td><td>?</td><td>?</td><td>?</td><td>?</td><td>V</td><td>V</td><td>X</td></tr>
<tr><td colspan="6">Criterion 2.2: "The jurisdiction should not facilitate offshore structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction"

In light of the assessment made under all Code criteria applied by analogy, the tax system of Marshall Islands should be considered overall harmful from a Code of Conduct point of view.

The main concerns on deviations from the Code of Conduct criteria as applied by analogy relate to the lack of legal substance requirements and the de facto lack of substance.</td><td colspan="2">Overall: V</td></tr>
</table>

Explanation

Absence of a corporate tax system or applying a nominal corporate tax rate equal to zero or almost zero: In this respect, where criterion 2.1 is inapplicable solely due to the fact that the jurisdiction concerned does not meet the gateway criterion under Paragraph B of the Code of Conduct, because of the "absence of a corporate tax system or applying a nominal corporate tax rate equal to zero or almost zero", then the five factors identified in paragraph B of the Code of Conduct should be applied by analogy to assess whether the criterion 2.2 has been met.
Relevant questions (Q 1.2) *Marshall Islands apply a territorial tax system. It does not, however, operate a corporate tax system as such – the taxes which are collected are 3% on gross revenue for **businesses**[8] and 10% withholding tax for **non-resident persons**[9] on income from services rendered to domestic clients cannot be regarded as Corporate Income Tax.* ***We therefore suggest this jurisdiction to meet the gateway test of the criterion 2.2. as a non-tax jurisdiction***

8 a business is any profession, trade, manufacture or other undertaking and includes all activities whether personal, professional, unincorporated or incorporated, carried on within the Republic of the Marshall Islands for economic benefit, either direct or indirect

9 a non-resident person is a person or body who is not permanently resident in the Republic of the Marshall Islands, or a business not registered in the Republic of the Marshall Islands, or an entity that carries on the business of operating ships in international traffic that is not incorporated in the Republic of the Marshall Islands and that does not have its central management and control, as determined by the place where its Board of Directors or equivalent body meets, in the Republic of the Marshall Islands, and who does not pay tax on wages and revenues and tax on gross revenue, including a firm, partnership, company or corporation, whether incorporated or unincorporated, or any other business entity

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Criterion 1: “whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents”
Relevant questions (Q 2.1, Q 2.2, Q 2.3, Q 1.1, Q 1.2, Q 1.5, Q 1.8,) *The answer of Marshall Islands on the number of registered legal entities states that there are **45,000** entities (called **active non-resident domestic entities**) which are exempt from any corporate profit tax, income tax, withholding tax and tax reporting requirements (2016), vs. **865** entities which are registered for tax purposes as doing business in the Marshall Islands (i.e. subject to these taxes) We were not able to establish the legal meaning of an “active non-resident domestic entity”, but taking into consideration the designation “non-resident” it could be that the advantages of being exempt from the above mentioned taxes are de jure accorded only to non-residents.* *We would therefore propose a question mark (“?”) for criterion 1a).* *There seems to be no difference between the de jure and de facto tax treatment of the above mentioned 45,000 active non-resident domestic entities and the 865 entities registered as doing business in the Marshall Islands.* *We would therefore propose a question mark (“?”) for criterion 1b).*
Criterion 2: “whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base”
Relevant questions (Q 2.1, Q 2.2, Q 2.3, Q 1.1, Q 1.2, Q 1.5, Q 1.8,) *By analogy to the assessment against criterion 1a/b. We would propose a question mark ("?") for criterion 2a) and a question mark (“?”) for criterion 2b).*

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Criterion 3: “whether advantages are granted even without any real economic activity and substantial economic presence within the jurisdiction offering such tax advantages”
Relevant questions (Q 1.1, Q 1.7, Q 1.9, Q 2.4, Q 2.5, Q 2.6, Q 2.7, Q 2.8) *The conditions attached to the advantages at stake (e.g. requirements for incorporation or operations) do not include any express requirement for real economic activity or substantial economic presence. This alone justifies a conclusion on the lack of substance.* *We would therefore propose a tick ("V" - harmful) for criterion 3.*
Criterion 4: “whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD”
Relevant questions (Q 2.9, Q 2.10, Q 2.11, Q 2.12) *Marshall Islands does not follow the OECD transfer pricing rules or any alternative transfer pricing rules for profit determination in line with internationally accepted principles. This situation seems to negatively affect a proper allocation of profits. We would therefore propose a tick (“V” – harmful) for criterion 4.*

Criterion 5: “whether the features of the tax system lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way”
Relevant questions (Q 2.13, Q 2.14, Q 2.15, Q 2.16) *All the elements of the legal system which are relevant for benefitting from the advantages at stake (including rules for the granting of tax residence or the setting up of companies) are clearly set by the law and the practice does not involve any administrative discretion. We would therefore propose a cross (“X” – not harmful) for criterion 5.*

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