



In the editorial of last year's September issue, a good friend of mine from the land of the Vikings noted that the punchline of my editorial provided little incentive for the prospective reader: "This left me with no other option than to immerse myself to the task I detest most; editing the newsletter." Thank you Mr S for pointing it out. And thank you for reading, at least, the editorial.

This year, I won't make the same unintentional mistake. I will therefore exalt the invaluable insight that the newsletter provides in trust, regulatory and accounting matters. Truth be told, I have always had an inkling for the articles which discuss trust cases (you will find this on the last page) and I guess this edition's feature will not leave you unsatisfied. After all, who doesn't relish the prospect of a story about Russian oligarchs?

Actually, this time round I was quite spoilt for choice in which current issues I should focus on; so, my task was far easier, if not enjoyable. The Manafort case was a close contestant but it didn't make it to the last round, most probably because I would end up talking about banks; and that I certainly detest doing.

People call me a cynic; I can only rebut this by quoting Oscar Wilde: "A cynic is what an idealist calls a realist".

Have a pleasant reading.

Pericles

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FIFTH AML DIRECTIVE – BACK WITH A VENGEANCE

The Fifth Anti-Money Laundering (AML) Directive was published earlier this summer in the Official Journal of the European Union and caused a widespread rush of enthusiasm and excitement in bureaucratic circles.

The Fifth AML Directive introduces a number of key changes to the existing regulatory framework:

- **Public registers of beneficial owners of companies.** EU member states should make such registers accessible to the general public. This does not include the register of equitable owners of trusts, which will still require applicants to demonstrate "a legitimate interest" before being granted such access.
- **Extension of supervision to other providers.** The current anti money laundering regime is extended to additional service providers such as dealers of art, providers of electronic wallets and virtual currency exchange service providers. These professionals will now be obliged to identify their customers and report any suspicious activity to the relevant authorities.
- **Extension for existing providers.** The current monitoring framework introduces further specifications regarding the scope of application of the Fifth AML Directive with respect to tax advisors and estate agents.

In addition to the above, other amendments are introduced such as:

- The threshold for identifying holders of prepaid cards is lowered to €150 and the limit to such cards for online transactions will be €50.
- EU member states will have to implement enhanced due diligence measures to monitor suspicious transactions involving high-risk countries more strictly.

EU Member States have 18 months (from 9 July 2018) to implement the Fifth AML Directive into national law, the deadline being 10 January 2020 deadline. Oh joy.



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NOTIONAL INTEREST DEDUCTION – A REFRESHER

Well, it's not really news but it is a wonderful reminder to those of us who have forgotten it.

The Cyprus government introduced a piece of legislation which, surprisingly enough, kills two birds with one stone; provides a tax benefit and enhances substance for Cyprus companies.

This scheme allows Cyprus companies to deduct from their profits a deemed cost of capital; the so-called Notional Interest Deduction (NID). NID is an allowable expense against the income from the asset which these funds were used to acquire or to fund. NID is calculated based on an interest rate specific to the country in which the asset is located (10-year government bond + 3% spread) multiplied by the new equity that has been injected into the company. The new equity may be in the form of share capital or share premium.

The most common application of this scheme is for financing entities. It comes to supersede the traditional structuring concept of the “back-to-back” loans, which is now obsolete. If you want to use a Cyprus company as a financing vehicle, you would nowadays do it in a more sophisticated way; capitalise the company with equity and then pass on the loan to the

borrower. The interest income from the borrower will be mitigated by the NID.

Naturally, there are the usual caveats in place. First of all, the deemed deduction may not exceed 80% of the taxable income. Secondly, this deduction only relates to capital injected post 1 January 2015. Thirdly, and though not explicitly clarified, the deemed expense has to be matched with an associated income.

Let's take a simple example to put things into perspective: Half-way in 2017, a company is financed with additional equity of €1,000,000 and advances a loan, for this very amount, in a South African entity. For 2018, the notional interest would be $€1,000,000 \times (8.78\% + 3\%) = €117,800$. Assuming that the interest income from this loan is €200,000, the entire notional interest can be deducted. Assuming that the interest income is €100,000, the maximum allowable deemed interest deduction would be €80,000.

Our above example is both simplistic and rudimentary. It would be much more involved if you have had the equity for only part of the year (you would need to pro-rate the NID), if you have multiple assets (you need to match the income with the expense of each asset or class of assets or activity), if you have unallocated capital that you need to apportion (you need to do it in a specific way) and so on. So, I guess, the main message is that you need to speak to your advisor prior to utilizing this tool. As a good friend of mine (he is a lawyer but he is still a good friend) once told me: “Don't confuse my (law) degree and experience with your internet search”.

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The English High Court, to which one of the creditors (DIA or Deposit Insurance Agency) applied found in the latter's favour, in a case that has serious ramifications in the trust business. The claimants, having being appointed as the liquidator of Mezhprom Bank, brought three alternative claims in order to lay their hands on the trusts' assets through Mr Pugachev:

- That the trusts were "illusory" and that Mr Pugachev had not divested himself of the assets.
- That the trusts were a sham, a claim that is normally associated with a high burden of proof.
- That the settlement was done with a view to defraud the creditors, under section 423 of the Insolvency Act.

The Court found for the claimants on all three counts; we will discuss the first two, which are the ones we consider to be of utter significance in trust case law.

The first claim was referred to as the "Illusory Trusts" claim (Mr Justice Birss: "The True Effect of the Trusts"). The claimants argued that on a proper construction of the trusts deeds, the trusts were not effective in divesting Mr Pugachev of his beneficial ownership of the trust assets. The claimants placed considerable emphasis on the fact that Mr Pugachev was the settlor, a discretionary beneficiary and the protector. Mr Justice Birss held that Mr Pugachev's powers as a protector of the trusts were personal powers and not fiduciary, in spite of the fact that most of these powers were negative i.e right of veto. As a result, Mr Pugachev exercised his duties for his own interests and not for the interests of the beneficiaries; notwithstanding the fact he was one of them. Mr Justice Birss emphasised that Mr Pugachev was also the settlor and one of the named discretionary beneficiaries. Mr Justice Birss also emphasised that, had the protector's powers been vested to an unrelated party, the decision might have differed.

The second claim was referred to as the "Sham" claim. The claimants argued that the trust deeds were shams and therefore the trusts had no effect. Mr Justice Birss noted that a trust is a sham if there is a common intention of all parties to the trust deed to give third parties the appearance of creating a trust whereas these same parties have no such intention; this is indeed an allegation which is notoriously difficult to prove. Mr Justice Birss found that Mr Pugachev had considered the assets which were settled in the trusts as being his own, never effectively relinquishing control thereof. Mr Pugachev, Mr Judge Birss found, had exercised this control through the extensive powers reserved for him as a protector and that the trustees had not advised Mr Pugachev of the fiduciary nature and fettered extent of his powers. Mr Justice Birss concluded that the both the trustees and Mr Pugachev had intentions which were perfectly aligned.

Conclusions

This case lends substantial support for an additional head of claim for a creditor who wishes to attack assets bequeathed in a trust. So far, the primary means for so doing had been to allege that the trust deed is a sham, which requires the claimant to show a common intention of all parties to create a misconception as to the existence of the trust at the time of setup – not so easy to prove, to say the least.

Creditors may now evaluate whether an individual (most likely, the settlor) has effective control and ownership of the trust assets through extensive powers vested in him or her as (say) a Protector. The Pugachev case is a stark reminder that trust practitioners must be overly careful when assigning powers to a protector or (even more precariously), depriving trustee powers in favour of a settlor.

CATHERINE THE GREAT, NEW ZEALAND AND RESERVED POWERS FOR SETTLORS OR PROTECTORS



The 18th century was a troublesome time for the Russia. Thankfully for the Empire, a Prussian aristocrat ascended to the throne; Catherine II or Catherine the Great as she would be eventually known. Catherine dealt with the insurgencies in her realm with fierce decisiveness, managing to preserve the integrity of Russia and to eventually expand its territory by about 50 times the size of Cyprus. One of the revolts she crushed was led by a certain Mr Yemelyan Pugachev, a peasant who claimed he was heir to the throne. Mr Pugachev was eventually defeated and met with a gruesome death in Bolotnaya Square, reminiscent of the violent executions that the aficionados of the “Game of Thrones” are accustomed with.

Two hundred years on, the name Pugachev was destined not to create troubles for the rightful head of the Russian state but, on the contrary, to go hand-in-hand with him. Another person bearing that surname, Mr Sergei Pugachev, was destined to become part of the inner circle of the Russian president. Born into a military family, Mr Pugachev rose in prominence (including election to the Senate in 2001) and wealth, becoming one of Russia’s most successful financiers. Amongst others, he founded Mezhprom Bank, which was one of Russia’s leading private banks. So far, so good.

The collapse of Mezhprom in 2010 left, as one would imagine, a plethora of hungry creditors whose aim was also directed at Mr Pugachev’s assets. What these creditors found out is that, between 2011 and 2013, Mr Pugachev settled around \$100 million worth of assets in five discretionary trusts in New Zealand, a country most famous for wine, rugby and being the birthplace of Sir Edmund Hillary. The assets which were bequeathed to these trusts included a £12m mansion in Chelsea and a \$40m luxury holiday home, Sand Club, in St

English High Court: Concentration of powers in the hands of the Protector may compromise trust arrangement

Barths in the Caribbean. Peanuts, when compared to the \$1bn of unsatisfied claims, but still sizable in absolute figures. Mr Pugachev, other than being the settlor, was also the discretionary beneficiary and the first protector, reserving a substantial number of powers for him; the latter, would prove to be of pivotal significance to the case and eventually work to his detriment. These powers included the power to dismiss the trustees, the right to request information from the trustees, the right to refuse to consent to the trustees’ exercise of their powers, the power to transfer the trust assets and so on and so forth.

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