



EDITORIAL

No doubt, two are the major events that have shocked the world in the past few months; the corona virus and Megxit.

The pandemic precipitated by the spread of corona virus over the globe has triggered extreme fear in financial markets as investors face up to an unsettling reality: pushing the world into a recession.

The decision of the Italian government to place the entire country into lockdown, along with an escalating outbreak in the United States and the ensuing crash in oil prices, is forcing economists to reassess their predictions for how the virus will hit growth. The world economy is facing a two-fold challenge. Factory closures, workers under quarantine and a serious shock on the supply chain, promulgated by the corona virus impact on China, the worst-hit region in the world. To add insult to injury, the hit on consumption is enormous, with many public events cancelled, people encouraged (or forced) to stay at home and avoid travel, slashed demand for flights, hotel rooms and restaurant bookings. The economic outlook, at the time of this editorial, is bleak.

The longer the pandemic lasts, and the more dramatic the efforts are to contain it, the more profound the effects will be for the global economy. Right now, with the situation being highly uncertain we are, at the risk of a cliché, facing uncharted waters.

Central banks all over the world have far less ammunition to deploy than they did in 2008. Interest rates in Europe and Japan were already in negative territory before the corona virus threat. Having cut interest rates by 0.50% in an emergency measure, the US Federal Reserve also has limited room to run. The Bank of England has slashed interest rates by 2/3, down from 0.75% to 0.25%, having to deal with the impact of the corona virus in addition to the disastrous short-term results of the exit from the European Union.

The silver lining of all of this doomsday news is that the (ensuing) recession will not require a long recovery period. It will be, most likely, followed by a speedy rebound. Which is more than can be said of the time period that the Royal Family will need to recover from Megxit.

Have a pleasant reading.

Pericles

WHAT'S ON TODAY'S EDITION?

OECD INTRODUCES
GUIDANCE ON TRANSFER
PRICING ON FINANCIAL
TRANSACTIONS

PAGE 2

FOUR JURISDICTIONS ADDED
TO EU NON-COOPERATIVE
LIST

PAGE 3

CERTAINTY OF TRUSTS,
VACUUM CLEANERS AND
DISNEYLAND

PAGE 4

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OECD introduces guidance on transfer pricing on financial transactions

Last month (assuming you are reading the newsletter in March), the OECD has issued its long-awaited guidance report on transfer pricing; the so called “Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10” (“Guidance”).

The Guidance has received a warm welcome amongst professionals, as it is specifically designed to improve international consistency in the transfer pricing of financial transactions. It does so by promoting a set of common standards and aims in reducing the risk of double taxation.

The Guidance is expected to have a material impact on the financial transactions of companies within the same group. It will be incorporated as Chapter X in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

The intention of the Guidance is to determine if conditions of financial transactions between related parties are consistent with the principle of conducting business affairs at ‘an arm’s length’. Some of the major areas it deals with are:

- How the ‘accurate delineation analysis’ of transactions advocated by the 2017 OECD Transfer Pricing Guidelines is to be applied to financial transactions.
- Guidance on determining risk-free and risk-adjusted rates of return.
- Determination of the arm’s length remuneration for intra-group loans.
- The transfer pricing of treasury functions, hedging, financial guarantees and so on.

One of the major items to take into account is the **debt-to-equity ratio** of the borrower and whether it corresponds to the arm’s length principle. Simply put, would an independent company, operating under similar conditions, agree to such a balance? Should that not be the case, then (part of) the loan may be considered as a contribution to equity, thus resulting in a reduced tax-allowable interest expense.

Another area of focus is the **credit rating** of the borrower. This is normally calculated using the financial statements of the borrower, along with publicly available credit risk calculators. Given that the borrower is part of a group, it is more likely than not to receive the group’s financial support, if needed. As a result, the fact that the borrower belongs to the group can affect its credit rating and, would consequently warrant a transfer pricing analysis.

Governments continue to focus on tackling the problem of the erosion of their tax base (BE) and the shifting of profits (PS). It has been a far -reaching target of the OECD since 2013, in adopting a 15-point Action Plan, to address BEPS. The package of BEPS measures was adopted by both the OECD and the G20 leaders in 2015.



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Four jurisdictions added to EU non-cooperative list

The finance ministers of the (recently-reduced-in-size) European Union have included four jurisdictions to the European Union's so-called blacklist of countries.

This list, whose membership is no doubt unenviable, includes the countries that the European Union deems to be 'non-cooperative jurisdictions for tax purposes'.

The four new additions to the list are the Cayman Islands, Palau, Panama and the Seychelles. All four countries had previously been on the so-called 'grey list' of jurisdictions that were assessed by the European Union as unsatisfactory in the last major update of the list in March 2019, but had committed to reform their business tax regimes by February 2020. The European Union's Economic and Financial Affairs Council (ECOFIN) said that all four jurisdictions have failed to reach this deadline.

Sixteen other grey-listed jurisdictions did deliver their reforms in a timely manner. As a result, these countries were upgraded to the European Union's white list. These countries are Antigua and Barbuda, Armenia, the Bahamas, Barbados, Belize, Bermuda, the British Virgin Islands, Cape Verde, Cook Islands, Curacao, Marshall Islands, Montenegro, Nauru, Niue, Saint Kitts and Nevis, and Vietnam. Turkey was given additional time to solve the remaining open issues.

The listed jurisdictions are subject to certain measures at the level of both the European Union and the individual member states. These measures include reporting obligations under Council Directive (EU) 2018/822 (mostly known as 'DAC6'). DAC6 requires the disclosure of cross-border arrangements that involve tax deductible cross-border payments, under circumstances where the end recipient is tax resident in a black listed jurisdiction. The measures that the member states may apply (with a view to prevent the erosion of their tax bases) include but are not limited to disallowance of costs, withholding tax or enhanced CFC rules.

(continued from page 4)

Certainty of intention

The Court, in considering the wording of the various agreements between Mr North and the investors, found that a trust had not been created, noting that the documentation had not been drafted by a lawyer and was "bordering on the incoherent". The agreements appeared to lack material items that would need to be normally dealt with in a trust instrument; how would the liabilities be accounted for by the parties, how would the business be managed if a trust were created and so on. The Court also pointed out that no allowance was made for the fact that the highly speculative nature of Mr North's venture could not be reconciled with the normally conservative nature of trusts.

The Court also found that the language used in the agreements was "inapposite to create a trust, all the more so in the light of the considerations rehearsed above". Although the intention to create a trust did not require the use of the word "trust" or similar language, the Court pointed out that there must be "a clear declaration of trust and that means there must be clear evidence from what is said or done of an intention to create a trust"¹. In finding for Mr North's sons, the Court held that there was no such clear evidence in the agreements, with "the obvious consequence of the failure is not a trust but, as was submitted by the appellants, a claim for damages against Mr North".

Disneyland

After the settlement that originally netted Mr North the \$17.8m, he had commented that he would take his family to Disneyland; don't know whether he did so.

¹ Paul v Constance [1977] 1 WLR 527

Certainty of trusts, vacuum cleaners and Disneyland

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Background

More than a decade ago, back in 2004, Mr John North, an engineer from Norwich, successfully settled a court case he had launched against a large manufacturer of electrical appliances. His claim was that the manufacturer had stolen his design of a vacuum cleaner. The trial had run for over three weeks in El Paso, Texas, before the two parties settled. The settlement allowed Mr North to net a settlement \$17.8m.

Here come the investors

Mr North's work in developing his breakthrough invention had been largely funded by nine investors, who all claimed that they had backed him with substantial funding in exchange for written and oral assurances that they would each receive back a multiple of their original investment (which he did indeed pay up) and a percentage of the profits. As Mr North refused to settle the latter, the case went to court.

High Court

The investors had argued that Mr North's out-of-court settlement with the manufacturer was in essence a profit of the venture which, by virtue of the arrangement they had with Mr North, was partly attributable to them. Their claim largely relied on (badly drafted) documents and agreements, supporting their assertion that Mr North had intended to create trusts in their favour and that they were entitled to a share of his assets.

The High Court held, with some hesitation, that Mr North had validly created trusts in favour of the investors and granted them a default judgment against Mr North for £2m. Permission to appeal was granted, a right which was taken up by his two sons, since Mr North had since then died.

Court of appeal

The Court of Appeal noted that in order to determine whether Mr North intended to create trusts in favour of the investors, the question was whether the three certainties were met — objects, subject matter and intention². Whereas the former was abundantly clear, with the investors being the *objects*, the latter two were not so easy to ascertain. We will consider the Court's view on these two in turn.

Certainty of subject matter

Mr North's sons claimed that there were "insurmountable difficulties in identifying the relevant assets", stating that it was not possible to separate the business from the non-business assets, with a sufficient degree of certainty. The submission was rejected by the Court, stating that even "constantly changing assets can form the subject of a valid trust". The Court further held that there was no "difficulty in a trust of a share of an indivisible asset, such as real property, intellectual property rights or book debts." The court concluded that the certainty of *subject matter* was also met and that the challenge lied on establishing *intention*.

(Continued on page 3)

² Knight v Knight (1840) 49 ER 58

