Pensions Audit Sub-Committee

10am, Friday, 20 September 2013

Investment Income Review - Cross Border Withholding Tax

Item number	5.2
Report number	
Wards	All

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Executive summary

Investment Income Review - Cross Border Withholding Tax

Summary

This report provides information on a benchmarking study prepared by KPMG into the effectiveness of the procedures in place to manage the tax exposure on the investment income of Lothian Pension Fund and Lothian Buses Pension Fund (not relevant to Scottish Homes Pension Fund as taxation matters are the responsibility of the pooled fund manager).

This is the first ever study that we have commissioned. It shows that the current arrangements are generally working well. However, it highlighted a delay in recovering tax on Swiss dividends; this has allowed us to take corrective action. In addition, there is a suggestion to improve the recovery of tax on Spanish dividends which we are implementing.

Recommendations

1. Pensions Audit Sub Committee should note the contents of this report and the action taken in response to the findings of the withholding tax benchmarking report.
2. Pensions Audit Sub Committee should approve the proposal to repeat the benchmarking of the investment income tax services provided by the custodian on a regular basis, with the findings reported to the Pensions Audit Sub Committee.

Measures of success

Success can be measured by the Pension Funds:

- Minimising exposure to tax on investment income.
- Obtaining prompt recovery of reclaimable income tax deducted at source.

Financial impact

The recoverable tax accrued during 2012/13 on Lothian Pension Fund was £814k; claims paid were £403k, leaving a balance to be recovered of £1,843k at 31 March 2013.For Lothian Buses Pension Fund, recoverable tax accrued during 2012/13 was £112k; claims paid were £5k, with the balance of £286k at 31 March 2013

The report contains a suggestion to potentially recover an additional £98k in tax on Spanish dividends. Steps have also been taken to accelerate the recovery of £385k in tax on Swiss dividends.

Provision has been made in the 2013/14 budget for the cost of a benchmarking report. A similar provision will be made in the 2014/15 budget if the Pensions Audit Sub Committee approves the recommendation to repeat the exercise in future years.

Equalities impact

None

Sustainability impact

None

Consultation and engagement

The Consultative Panel for the Lothian Pension Funds, comprising employer and member representatives, is integral to the governance of the Funds.

Background reading / external references

None

Report

Investment Income Review - Cross Border Withholding Tax

1. Background

The Taxation Environment

1.1 Lothian Pension Fund (LPF) and Lothian Buses Pension Fund (LBPF) invest directly in stock markets across the globe. These investments generate income that is potentially liable to income tax in the country of tax domicile. During the 2012/13 financial year the Pension Funds earned income from companies in 46 different countries.

1.2 UK pension funds are usually able to benefit from beneficial tax rates. These rates are normally determined by separate tax treaties established between the UK Government and most foreign countries. Tax on dividends varies between 0% and 35%. In contrast, income on fixed interest stocks is usually free from tax.

1.3 In virtually all countries income is subject to taxation at source, so the owner of the investments receives the income net of the appropriate amount of tax. Taxation deducted in this way is called withholding tax or WHT for short.

1.4 In some countries the preferential rate for UK pension funds is subject to providing the tax authorities of the country concerned with an application and supporting paperwork. The exact requirements vary from country to country and in some cases can be quite onerous. Failure to have preferential rate approval in place means that income will be subject to a higher rate of tax than is necessary.

1.5 The preferential rate may be applied at source, meaning that there is no tax to reclaim from the foreign tax authority. Alternatively, the rules of the country may require tax to be deducted at the full rate with a subsequent claim having to be made to the tax authority to get repayment of the difference between the full rate and the preferential rate.

1.6 The requirements to make a valid repayment claim and the time it takes for the claim to be paid vary considerably from country to country.

1.7 With the exception of India, realised investment gains are generally not subject to UK or overseas capital gains tax.

The Role of the Custodian

1.8 The custodian appointed for the three pension funds is Northern Trust (NT). The Scottish Homes Pension Fund is invested in pooled funds, so there is no requirement to recover income tax as this is organised by the pooled fund manager.

1.9 In addition to the vital roles of holding title to investments on behalf of the investor, the global investment custodian is responsible for the management of the procedures and processes that relate to the taxation of investment income.

The Scale of Activity

1.10 The table below shows the movement in the reclaimable tax balances during the 2012/13 financial year for both Lothian Pension Fund and Lothian Buses Pension Fund. Also included in the table is the amount of tax suffered by each fund that is not recoverable.

	Lothian Pension Fund £		**Lothian Buses Pension Fund £**
Brought Forward 1 April 2012	1,431,621.30		179,179.25
Recoverable tax accrued during year	814,393.53		112,175.17
Claims paid during year	(403,450.78)		(5,119.09)
Carried Forward 31 March 2013	1,842,564.05		286,235.33
Irrecoverable Tax Deducted 2012/13	1,965,527.37		70,543.81

1.11 The year end recoverable tax balances at 31 March 2013 are broken-down by country in the table below.

Country	**Lothian Pension Fund**			**Lothian Buses Pension Fund**	
	Reclaim Amount £	**Number of Dividends**		**Reclaim Amount £**	**Number of Dividends**
Austria	8,588.53	14			
Belgium	76,929.38	6			
Denmark	8,587.24	8			
France	57.19	1			
Germany	79,234.52	86			
Ireland	1,440.28	1			
Japan	40,872.39	13		600.74	1
Jersey, Channel Islands	212.64	1			
Netherlands	17,331.36	5			
Norway	87,019.34	17		8,942.53	3
Poland	11,152.77	1			
South Africa	13,952.69	9		2,278.21	2
Spain	36,244.42	58			
Switzerland	1,419,422.68	48		265,639.60	9
United Kingdom	41,518.62	4		8,774.25	1
Grand Total	**1,842,564.05**	**272**		**286,236.33**	**16**

1.12 For Lothian Pension Fund, Switzerland accounts for 77% for the total amount receivable and for Lothian Buses Pension Fund the percentage for Switzerland is 93%. Apart for claim delays, the reason why the Swiss total claim value is so large is that 35% tax is deducted on all dividends and the 0% rate relief is obtained by claiming the tax paid back. There are few other countries where the tax deducted at source is so high. Swiss tax is discussed further in the Main Report below.

2. Main report

Benchmarking Study

2.1 Given the complexity and scale of the taxation of investment income, it is important that Northern Trust (NT) provides an efficient service. Failure to ensure that the correct tax rates are being applied would result in a direct loss of income. Poor management of the tax reclaim process could mean that recoverable tax is never recovered or unnecessarily delayed.

2.2 In order to assess the effectiveness of NT's work, KPMG has been commissioned to prepare a benchmarking report. KPMG's remit was:

- Review the most recent withholding tax table produced by NT and verified the withholding tax rates that have been applied to income received from a number of source countries;
- Identify areas where there is opportunity for greater relief from withholding tax than that currently being applied;
- Quantify the amount of withholding tax that could potentially be reclaimed for the chosen study period (September 2011 to September 2012);
- Review the withholding tax reclaims that have already been processed by NT and assess their timeliness.

2.3 This is the first time that we have commissioned a study of the effectiveness of the investment income tax service provided by our custodian. The intention is to repeat the benchmarking on an annual basis so that progress can be monitored over time.

Summary of the Findings

2.4 The study concluded that generally NT has been applying the appropriate withholding tax rates for a UK pension fund. However, they have identified a small number of issues:

- A 0% tax rate has been available in Spain since 1 January 2011. However, NT has been applying an effective rate of 15%. This is because there are significant practical issues with the process of obtaining the 0% rate, which have been acknowledged by KPMG.. As NT is currently unable to obtain the 0% rate, KPMG has been asked to make claims on behalf of LPF. Currently the potential benefit is around £98k.

- A 10% rate is available in Taiwan; NT is currently able to achieve 20%. To achieve the 10% rate requires the appointment of a tax accountant in Taiwan. Prior to the benchmarking study, LPF has appointed the local office of KPMG to proceed with appropriate claims in Taiwan. Currently the potential benefit is around £54k.
- Small potential recoveries were identified for Indonesia (£18k) and the Philippines (£10k). In both cases the lowest rate of withholding tax can only be achieved by appointing a local tax accountant. KPMG have confirmed that based on the current reclaim levels it would not be economic to make either claim.

2.5 The reclaim process consists of the custodian preparing an application in the required format for the country concerned. Once the application has been lodged with the tax authorities of the country, it will take the authority an amount to time to process the claim and pay the refund to. This processing time varies from country to country – some take a matter of months and others will take a number of years. KPMG have identified four countries where the reclaim times achieved appear to be longer that expected:

- The study found that in Switzerland claims were taking more that two years compared to an expectation of one year. This has now been pursued successfully, with the claim now received for the 2011 calendar year (value around £385k). The custodian has also tightened its procedures to expedite the despatch of Swiss tax vouchers to HMRC for certification (a procedure that is necessary before the claim is filed in Switzerland.
- For Belgium, KPMG has identified £74k that has taken more than 5 years to be repaid, compared to an expectation of one year. However, KPMG was not aware that the claims relate to the previous custodian (Citibank). When a custodian is changed, the old custodian remains responsible for claims made during its tenure of office until such times as the amounts are cleared. We are working with Citibank to determine if there is a realistic prospect of the claims being paid.
- KPMG has asserted that LPF is eligible to claim the reduced rate for pension funds in Austria. This has been challenged by the custodian and LPF is in discussions to resolve matters. The value of outstanding Austrian claims at 31 March 2013 is £8k.
- The delays identified for Ireland are historic; four dividends received in 2011 were subject to a tax claim. Three have now been paid since the study. No additional claims have been added as a withholding tax rate of 0% is now being applied at source. The value for outstanding Irish claims at 31 March 2013 is £1k.

2.6 The appendix to this report summarises all the findings of the benchmarking report, any additional comments received from KPMG and the custodian and progress made so far in progressing the findings.

3. Recommendations

3.1 Pensions Audit Sub Committee should note the contents of this report and the action taken in response to the findings of the withholding tax benchmarking report.

3.2 Pensions Audit Sub Committee should approve the proposal to repeat the benchmarking of the investment income tax services provided by the custodian on a regular basis, with the findings reported to the Pensions Audit Sub Committee.

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Director of Corporate Governance

Links

Coalition pledges	
Council outcomes	CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.
Single Outcome Agreement	
Appendix	Summary of the findings of the withholding tax benchmarking report

Appendix - Summary of the findings of the withholding tax benchmarking report

Country	Findings	Conclusions as at Date of Report to Pensions Audit Sub-Committee
Australia	"Franked" dividends are exempt from withholding tax (WHT) in Australia. Under Australian domestic legislation, LPF should also be entitled to a 0% rate of WHT on "unfranked" dividends received from Australia if they have obtained a ruling from the Australian Tax Authorities showing that they are comparable to an Australian superannuation fund. It is unclear whether this clearance has been obtained as 9 dividends have been subjected to WHT at rates from 7.5% to 15%. LPF could be entitled to refunds of these amounts if the necessary clearance has been obtained. The total tax leakage across these dividends is AU$9,963 (£5,800).	We are awaiting confirmation from NT that the preferential rate has been approved by the Australian Tax Authorities. The additional tax deducted will be reclaimed.
Austria	Some of the Austrian reclaims have been made within the expected timescale of 9-12 months however reclaims totalling £4,910.51 have been received after more than a year.	Awaiting comments from NT.
Belgium	Reclaims in Belgium generally appear to be taking in excess of 5 years to recover. This is far in excess of the 2 year market standard. The amounts reclaimed exceeding 5 years per the report provided by NT total £73,748.47.	As at 30 June 2011, the amount outstanding that relates to the previous custodian amounts to £42k. We are in contact with the custodian to confirm the status of the claims.
Indonesia	Dividends received from Indonesia have suffered the standard domestic rate of 20%. A reduced rate of 15% is available under the Indonesia/UK Treaty. There is a potential tax leakage of approximately £18,150. We recommend that you discuss this with your custodian.	Both NT and KPMG confirm that it is not economic to reclaim such small amounts of tax.
Ireland	Reclaims in Ireland are taking longer than the 8 months expected, they appear to be taking between 12 months and 24 months.	The problem is historic; four dividends received in 2011 were subject to a tax claim. Three have now been paid and no additional claims have been added as a WHT rate of 0% is now being applied at source.
Israel	The standard domestic rate of WHT in Israel is 25%. NT appears to be applying the rate under the Israel/UK Treaty of 15%. In our opinion, this reduced rate should not be available to a UK resident pension fund as the Treaty contains a "subject to tax" clause which LPF is unlikely to satisfy. We recommend that you discuss this with NT to understand the basis on which they are making the claim.	Only five dividends from Israel have been received in the period 1 April 2012 to 31 July 2013. Issue has been discussed with NT and we have decided to take no further action.

Country	Findings	Conclusions as at Date of Report to Pensions Audit Sub-Committee
Korea	Several Korean dividends are suffering WHT at the standard domestic rate of 22%. LPF is entitled to a reduced rate of 15% under the Korean/UK Treaty. In August 2012, new documentation requirements were put in place by the Korean Tax Authorities. You should ensure that the custodian now has the required documentation and hence is obtaining relief at source going forward and that they will be applying for a refund of the over withheld tax. The potential tax leakage in this case is approximately £875.	Updated documents have now been provided to NT. Situation will be monitored until the reduced rate has been obtained.
Norway	The withholding tax rate applicable to LPF in Norway is 15% under the Norway / UK tax treaty. Under Norwegian domestic law EEA resident companies are entitled to an exemption, in practice the Norwegian Authorities have also been accepting reclaims from pension funds under this exemption. It is unlikely that the Norwegian Tax Authorities will seek to recover this potentially under paid tax.	NT is making claims to recover the 15% tax from the Norwegian tax authorities.
Philippines	The standard rate of WHT of 30% has been applied to dividends received from the Philippines. A reduced rate of 25% should be available to LPF under the Philippines/UK Treaty. The tax leakage identified is approximately £9,720. We recommend that you raise this with your custodian.	Both NT and KPMG confirm that it is not economic to reclaim such small amounts of tax.
Poland	A dividend received from Poland has suffered WHT at a rate of 10%. This is the reduced rate under the Poland/UK Treaty. It is possible for UK pension funds to obtain a 0% rate in Poland if they can prove that they are comparable with a Polish pension fund. The potential tax leakage is £2,292. This is potentially an expensive process and therefore may not be commercially viable but we recommend that you discuss obtaining this additional relief with your custodian.	Given LPF does not currently invest in any Polish companies it does not seem cost effective to take this further.
Spain	Some Spanish dividends have suffered WHT at a rate of 0% in line with the Spanish domestic exemption available to UK pension funds. However, a number have been taxed at a rate of 15% in line with the Spain/UK Treaty. The potential tax leakage is approximately £97,900. We would recommend that you speak to your custodian about obtaining additional relief for these dividends.	The withholding tax rate being applied by NT is 21%, they are then making tax reclaims which reduces the tax suffered to 15%. KPMG are saying that a 0% rate should be available from 1 January 2011. Given the difficulties referred to by KPMG, they have been asked to make claims to recover the 15% until this is offered by NT.
Switzerland	Whilst the majority of reclaims in Switzerland have been received within 12 months, the industry standard, a significant minority totalling £472,845.58 has taken up to two years to	Last Swiss reclaim receipt January 2012. NT have been asked why no receipt in 2013 to date. NT have advised that the claim for the 2011 calendar year (value around £385k) has been held-up in

Country	Findings	Conclusions as at Date of Report to Pensions Audit Sub-Committee
	recover. This may be accounted for by the nature of the Swiss reclaim system which only allows for a limited number of claims to be made each year.	the NT office in London for over 10 months. NT has now promised to forward the claim to Switzerland without further delay.
Taiwan	Dividends received from Taiwan are suffering WHT at a rate of 20%. Under the Taiwan/UK Treaty a reduced rate of 10% should be available to LPF. The potential tax leakage is approximately £54,000. We understand that KPMG are already assisting with obtaining relief in this market.	KPMG is already making claims on behalf of LPF.