Pensions Audit Sub Committee

2.30pm, Tuesday, 16 December 2014

Investment Income Review – Cross Border Withholding Tax

Item number	5.6
Report number	
Executive/routine	
Wards	All

Executive 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.

The benchmarking report prepared by KPMG shows that Northern Trust is generally applying the correct withholding tax rates on investment income and that recovery claims are generally processed within satisfactory timescales However, two important issues have been identified that need further investigation:

1. Subject to further investigation; it may be possible to recover around £362k of tax suffered on US dividends.
2. Swiss claims, around 80% of the total claims outstanding for Lothian Pension Fund, are taking over 2 years to recover, in comparison to KPMG's expectation of 12 months.

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	

Report

Investment Income Review – Cross Border Withholding Tax

Recommendations

1.1 Committee is requested to:

- Note the contents of the report;

Background

The Taxation Environment

2.1 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 2013/14 financial year the Pension Funds earned income from companies in 47 different countries.

2.2 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.

2.3 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.

2.4 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.

2.5 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.

2.6 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.

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

The Role of the Custodian

2.8 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.

2.9 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

2.10 The tables below show the movement in the reclaimable tax balances during the 2013/14 and 2012/13 financial years 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	**2013/14 £**		**2012/13 £**
Brought Forward 1 April	1,842,564.05		1,431,621.30
Recoverable tax accrued during year	1,751,330.62		814,393.53
Claims paid during year	(1,062,852.44)		(403,450.78)
Carried Forward 31 March	2,531,042.23		1,842,564.05
Irrecoverable Tax Deducted	2,001,907.34		1,965,527.37

Lothian Buses Pension Fund	**2013/14 £**		**2012/13 £**
Brought Forward 1 April	286,235.33		179,179.25
Recoverable tax accrued during year	168,919.59		112,175.17
Claims paid during year	(134,895.62)		(5,119.09)
Carried Forward 31 March	320,259.30		286,235.33
Irrecoverable Tax Deducted	98,054.54		70,543.81

2.11 In the case of both funds there have been considerable increases in both the amount of recoverable tax accruing during the year and the claims received. The amount of recoverable tax accruing is a function of a number of factors, including the level of investment income and the tax policies of the countries in which the dividends were earned.

2.12 The year end recoverable tax balances at 31 March 2013 and 31 March 2014, broken-down by country for both Lothian Pension Fund and Lothian Buses Pension Fund are provided in the tables below.

Lothian Pension Fund	**Reclaim Amount 31/3/14 £**	**Number of Dividends 31/3/14**		**Reclaim Amount 31/3/13 £**	**Number of Dividends 31/3/13**
Austria	23,663.09	31		8,588.53	14
Belgium	41,106.58	5		76,929.38	6
Canada	15,117.68	7		-	-
Denmark	979.88	1		8,587.24	8
France	3,196.29	3		57.19	1
Germany	11,958.49	4		79,234.52	86
Ireland	-	-		1,440.28	1
Japan	24,188.83	10		40,872.39	13
Jersey, Channel Islands	-	-		212.64	1
Netherlands	34,911.14	6		17,331.36	5
Norway	115,841.23	10		87,019.34	17
Poland	10,934.80	1		11,152.77	1
South Africa	-	-		13,952.69	9
Spain	-	-		36,244.42	58
Switzerland	2,100,482.41	61		1,419,422.68	48
United Kingdom	146,100.43	14		41,518.62	4
United States	2,561.38	3			
Grand Total	**2,531,042.23**	**156**		**1,842,564.05**	**272**

Lothian Buses Pension Fund	**Reclaim Amount 31/3/14 £**	**Number of Dividends 31/3/14**		**Reclaim Amount 31/3/13 £**	**Number of Dividends 31/3/13**
Canada	783.78	4		-	-
Denmark	243.32	1			
Germany	3,194.38	2		-	-
Japan	499.52	1		600.74	1
Netherlands	419.08	1		-	-
Norway	7,025.68	4		8,942.53	3
South Africa				2,278.21	2
Switzerland	307,589.08	12		265,639.60	9
United Kingdom	504.56	1		8,774.25	1
Grand Total	**320,259.30**	**26**		**286,236.33**	**16**

2.13 For Lothian Pension Fund, Switzerland accounts for 83% (77% at 31 March 2013) for the total amount receivable and for Lothian Buses Pension Fund the percentage for Switzerland is 96% (93% at 31 March 2013). 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.

2.14 The tables below demonstrate that despite the rise in recoverable tax balances the relative age of the amounts due is not deteriorating.

Lothian Pension Fund	**Reclaim Amount 31/3/14 £**	**Reclaim Amount 31/3/14 %**		**Reclaim Amount 31/3/13 £**	**Reclaim Amount 31/3/13 %**
Within 1 Year	1,360,494.57	54		973,775.90	53
1 to 2 Years	698,389.41	28		566,302.53	31
2 to 3 Years	331,383.13	13		210,070.35	11
Older than 3 Years	140,775.12	5		92,415.27	5
Grand Total	2,531,042.23	100		1,842,564.05	100

Lothian Buses Pension Fund	**Reclaim Amount 31/3/14 £**	**Reclaim Amount 31/3/14 %**		**Reclaim Amount 31/3/13 £**	**Reclaim Amount 31/3/13 %**
Within 1 Year	163,074.61	51		125,608.59	44
1 to 2 Years	101,105.73	32		108,156.97	38
2 to 3 Years	56,033.96	17		52,569.77	18
Older than 3 Years	-	-		--	-
Grand Total	320,259.30	100		286,235.33	100

Main report

Benchmarking Study

3.1 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.

3.2 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 verify 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 (12 months to 31 August 2014);
- Review the withholding tax reclaims that have already been processed by NT and assess their timeliness.

Findings – WHT Rates

3.3 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 opportunities and issues.

3.4 The most significant opportunity identified is 21 dividends from US investments that have suffered WHT at 35%. The entitled rate in the US is 0%, subject to further investigation; it may be possible to recover around £362k.

3.5 The main issues and the actions taken are summarised in the Appendix to this report. At the time of preparing this report we are awaiting responses from NT, a verbal update will be provided at the meeting.

Findings – WHT Claims

3.6 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.

3.7 The KPMG report identified a number of examples of delays in refunds being made, but with the exception of the Swiss claims the amounts involved were relatively low.

3.8 As at 31 March 2014, Swiss claims accounted for 83% of the total claims outstanding for Lothian Pension Fund. Last year's report to Committee highlighted Swiss claims were taking more that two years compared to an expectation of one year. As a result of discussions with NT it was reported that procedures had been tightened to reduce the time claims were taking to process. Unfortunately, this year's report indicates that there has apparently been no improvement. As at 31 October 2014, the claims for the calendar year 2012 amounting to £541k remain outstanding. An explanation is being sought from NT and a verbal report will be given at the meeting.

3.9 The other issues and the actions taken are summarised in the Appendix to this report. At the time of preparing this report we are awaiting responses from NT, a verbal update will be provided at the meeting.

Measures of success

4.1 Minimising exposure to tax on investment income.

4.2 Obtaining prompt recovery of reclaimable income tax deducted at source.

Financial impact

5.1 The recoverable tax accrued during 2013/14 on Lothian Pension Fund was £1,751k (£814k 2012/13); claims paid were £1,063k (£403k 2012/13), leaving a balance to be recovered of £2,531 at 31 March 2014 (£1,843k at 31 March 2013). For Lothian Buses Pension Fund, recoverable tax accrued during 2013/14 was £169k (£112k 2012/13); claims paid were £135k (£5k 2012/13), with the balance of £320k at 31 March 2014 (£286k at 31 March 2013).

5.2 The KPMG report contains a suggestion to potentially recover an £362k in tax on US dividends and apparent delays in recovering tax on Swiss dividends are being investigated.

Risk, policy, compliance and governance impact

6.1 There are no risk, policy, compliance and governance impacts arising from this report.

Equalities impact

7.1 There are no adverse equalities impacts arising from this report.

Sustainability impact

8.1 There are no adverse sustainability impacts arising from this report.

Consultation and engagement

9.1 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

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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	
Appendices	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 WHT Rate	"Franked" dividends are exempt from 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 30 dividends have been subjected to WHT at rates from 8.79% to 30%. 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$63,547 (£ 34,603).	KPMG raised the question of the ruling in their previous report. We contacted NT and established that a ruling had been agreed with the Australian tax authorities for the period 1 July 2012 to 30 June 2015. In most cases the 0% ruling has been applied. Therefore, the non-application of the ruling to what appears to be a random selection of dividends has been raised with NT.
Belgium WHT Claims	Belgian Reclaims should be refunded within 36 months. 4 Tax reclaims have been outstanding for more than 89 months. Whilst we note that their current status is "Prior Custodian Accrual" it is important that these reclaims have been submitted within the 5 year statute of limitations.	Investigation has shown that the 4 old claims referred to were recovered by the prior custodian and sent to NT in January 2014. We have contacted NT to ensure that the funds are traced and the debtors cleared. The amount involved is €59,288.50.
Canada WHT Rate	Generally, dividends received from Canada suffer a WHT rate of WHT of 15%. 2 dividends from the National Bank of Canada have suffered 25% WHT. The over-withholding totals CD$ 7,227 (£4,020).	Awaiting comments from NT.
Dominican Republic WHT Rate	A rate of 10% applies to Dominican Republic government bonds. There are 3 Dominican Republic 5.875% 18/04/24 which have been paid gross. The potential under withholding totals US$ 5,630 (£3,548) however, these may be manufactured payments.	Confirmed that the payment was not manufactured. Awaiting comments from NT.
Indonesia (Dividends) WHT Rate	A 15% dividend WHT is available to LPF; however 4 dividends (Gudang Garam TBK, PT Media Nusantara and 2 x Unilever Indonesia) have been paid at a rate of 20%. The total tax leakage on these dividends is IDR 54,819,250. (£2,840).	Awaiting comments from NT.
Indonesia (Interest) WHT Rate	A 10% interest WHT is available to LPF; however 7 corporate bond payments in Pertamina have been paid gross. The potential under-withholding is US$10,120 (£6,380). These bonds have US ISIN numbers and may have been treated as US source income.	Awaiting comments from NT.

Japan WHT Rate	A 0% rate is available to LPF, however 1 dividend (NTT Docomo – Due 20 June 2014) has been taxed at 15.31% (£4,453.41). It is not clear why this has occurred and whilst we are aware that a refund of the WHT was paid at a later date we recommend that you raise this with your custodian.	Awaiting comments from NT.
Japan WHT Claims	8 Japanese reclaims have been submitted to the sub-custodian. Reclaims should not be necessary as relief at source is available.	Awaiting comments from NT.
Kazakhstan WHT Rate	The domestic WHT rate in Kazakhstan is 15%, however the Kazmunaigas Exploration dividend paid on 1 July 2014 was taxed at 20%. There is currently no process for relief at source or reclaims in Kazakhstan, so we suggest you raise this with your custodian. The potential tax leakage is US$ 11,086 (£6,975).	Awaiting comments from NT.
Netherlands WHT Claims	Netherlands reclaims should be refunded within 12 months. 2 reclaims have been outstanding for 17 months and 1 reclaim has been outstanding for 42 months.	Awaiting comments from NT.
Philippines WHT Rate	The standard rate of WHT of 30% has been applied to all 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 US$12,904 (£8,114). We recommend that you raise this with your custodian, however as these amounts relate to ADRs it may be extremely difficult to recover this tax.	Awaiting comments from NT. Awaiting comments from NT.
Poland WHT Claims	Polish reclaims should be refunded within 12 months. 1 reclaim has been outstanding for 40 months, and currently has the status "Certification requested".	Value is around £11k.
Russia WHT Rate	LPF has received most dividends at the correct WHT rate of 15%, however 5 were paid at 10%. This is the rate under the Russia/UK Treaty, however, as the Treaty contains a subject to tax clause LPF should not be entitled to this rate. The under-withholding totals US$ 28,102 (£17,709).	Awaiting comments from NT.
Switzerland WHT Claims	Numerous Swiss reclaims have been outstanding for longer than the expected timeframe. We are aware that Switzerland only allows 1 claim per year, and that some custodians have faced issues in this market previously. However the majority of these claims should now have been submitted by the custodian and the ability to consolidate different years onto one reclaim form should reduce the amount of time the refund should take.	KPMG expect Swiss claims to take 12 months to recover. It is evident that NT claims are taking more than twice that amount of time. However, the NT report indicates that they regard only one dividend to be outside their normal claim parameter for Switzerland. Given the value of the claims we are pressing NT for an early response. Awaiting comments from NT.

Taiwan WHT Rate	Dividends received from Taiwan are suffering WHT at a rate of 20%. Under the Taiwan/UK tax treaty a reduced rate of 10% should be available to LPF. The potential tax leakage is TWD 4,742,400 (£97,527). We understand that you are aware of this and are making reclaims separately.	Confirmed that a claims procedure is in place.
USA WHT Rate	LPF is entitled to a 0% WHT rate on dividends in the United States. 21 dividends have suffered a 35% WHT. The tax leakage identified is approximately US$ 576,305 (£362,319). These payments relate to US listed partnerships therefore a reclaim should be available.	Awaiting comments from NT.
USA WHT Claim	1 United States reclaim has been outstanding for 35 months. The stock is actually Irish and therefore we would normally expect relief at source to have been applied, or alternatively repayment within 6 months.	There are 3 US claims outstanding with a total value of £2.5k.