

Pensions Audit Sub Committee

2.00 p.m., Monday, 5 December 2016

Investment Income Review Cross Border Withholding Tax

| | |
|-------------------|-----|
| Item number | 5.4 |
| Report number | |
| Executive/routine | |
| Wards | All |

Executive summary

This report provides information on a benchmarking study prepared by E&Y 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 E&Y shows that Northern Trust is generally applying the correct withholding tax rates on investment income. Recovery claims are being processed and reclaims received but E&Y feel that the time taken seems to be longer than the market standard for refunds. Claims due at 31 March 2016 are at the same levels as the previous year, meaning that the claims paid are balanced by new claims made.

Links

Coalition pledges

Council outcomes

[CO26](#)

Single Outcome Agreement

Investment Income Review Cross Border Withholding Tax

Recommendations

Committee is requested to:

- 1.1 Invite the Pension Board to raise any relevant matters or concerns which the Committee should consider; and
- 1.2 Note the report and highlight any points it would like to raise at the Pensions Committee on 6 December 2016.

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 2015/16 financial year the Pension Funds earned income from companies in 45 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.

The Role of the Custodian

- 2.7 The custodian appointed for the three pension funds is Northern Trust (NT). In addition to the vital role 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 – Lothian Pension Fund and Lothian Buses Pension Fund

- 2.8 The tables below show the movement in the reclaimable tax balances during the 2015/16 and 2014/15 financial years for both Lothian Pension Fund and Lothian Buses Pension Fund.

| Lothian Pension Fund | 2015/16 £ | 2014/15 £ |
|-------------------------------------|---------------------|---------------------|
| Brought Forward 1 April | 3,937,409.41 | 2,531,042.23 |
| Recoverable tax accrued during year | 2,113,859.80 | 2,062,513.96 |
| Claims paid during year | (2,052,596.20) | (656,146.78) |
| Carried Forward 31 March | 3,998,673.01 | 3,937,409.41 |

| Lothian Buses Pension Fund | 2015/16 £ | 2014/15 £ |
|-------------------------------------|---------------------|---------------------|
| Brought Forward 1 April | 476,181.59 | 320,259.30 |
| Recoverable tax accrued during year | 202,692.33 | 189,959.71 |
| Claims paid during year | (244,895.23) | (34,037.42) |
| Carried Forward 31 March | 433,978.69 | 476,181.59 |

- 2.9 For both funds the balance of recoverable tax at 31 March 2016 is broadly comparable to the balances at the preceding year. This is due to the amount of additional tax accruing during the twelve months being approximately the same as the claims paid. Claims paid during 2015/16 are considerably higher than 2014/15.
- 2.10 The year end recoverable tax balances at 31 March 2016 and 31 March 2015, 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 31/3/16 £ | Number of Dividends 31/3/16 | Reclaim Amount 31/3/15 £ | Number of Dividends 31/3/15 |
|-----------------------------|---|--|---|--|
| Austria | 38,001.16 | 16 | 34,795.27 | 31 |
| Belgium | 33.37 | 1 | 30.45 | 1 |
| Canada | 4,526.36 | 2 | - | - |
| Denmark | 8,280.04 | 5 | 1,041.69 | 3 |
| France | 37,744.04 | 25 | 6,279.24 | 4 |
| Germany | 138,136.59 | 21 | 17,720.39 | 10 |
| Israel | 12,598.08 | 3 | 1,613.34 | 1 |
| Japan | - | - | - | - |
| Netherlands | 178,050.13 | 22 | 55,868.52 | 9 |
| Norway | 445,730.33 | 26 | 240,655.91 | 12 |
| Poland | 14,250.66 | 2 | 13,544.28 | 2 |
| Russian Federation | - | - | 23,301.70 | 1 |
| South Africa | - | - | 532.56 | 1 |
| Spain | 15,090.80 | 4 | 245,452.03 | 67 |
| Sweden | 326.30 | 1 | - | - |
| Switzerland | 2,918,336.47 | 46 | 3,078,224.96 | 77 |
| United Kingdom | 187,568.68 | 11 | 216,945.77 | 17 |
| United States | - | - | 1,403.30 | 2 |
| Grand Total | 3,998,673.01 | 185 | 3,937,409.41 | 238 |

| Lothian Buses Pension Fund | Reclaim Amount 31/3/16 £ | Number of Dividends 31/3/16 | Reclaim Amount 31/3/15 £ | Number of Dividends 31/3/15 |
|-----------------------------------|---|--|---|--|
| Denmark | 2,414.66 | 3 | 91.72 | 1 |
| France | 7,190.49 | 2 | - | - |
| Germany | 19,568.27 | 4 | 4,302.45 | 2 |
| Italy | 885.75 | 1 | - | - |
| Japan | - | - | 4,343.42 | 1 |
| Netherlands | 14,499.30 | 5 | 5,051.26 | 2 |
| Norway | 61,318.63 | 14 | 34,592.56 | 7 |
| Spain | 2,396.08 | 1 | 2,186.45 | 1 |
| Switzerland | 305,725.80 | 15 | 414,841.70 | 18 |
| United Kingdom | 19,979.71 | 5 | 10,772.03 | 3 |
| Grand Total | 433,978.69 | 50 | 476,181.59 | 35 |

2.11 For Lothian Pension Fund, Switzerland accounts for 73% (78% at 31 March 2015) for the total amount receivable and for Lothian Buses Pension Fund the percentage for Switzerland is 70% (87% at 31 March 2015). 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.

2.12 The Swiss, German, Dutch and Norwegian claims are discussed in more detail later in this report.

Scottish Homes Pension Fund

2.13 The Scottish Homes Pension Fund is mainly invested in pooled funds, so there is no requirement to recover income tax as this is organised by the pooled fund manager.

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 delayed.

3.2 In order to assess the effectiveness of NT's work, Ernst & Young (E&Y) has been commissioned to prepare a benchmarking report. E&Y's remit was:

- Review the withholding tax rates applied by NT and verify these with a database of rates prepared by E&Y;
- 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 2016);
- Review the withholding tax reclaims that have been processed by NT and assess their timeliness.

Findings – WHT Rates Applied

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 number of opportunities and issues. These are summarised in the Appendix to this report. NT has responded to the points raised and their comments are included in the Appendix. As at the date of preparing this report we are working to clarify some remaining points on Denmark, France and Germany. A further update will be provided at the Sub Committee meeting.

Findings – WHT Claims

3.4 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 of time to process the claim and pay the refund. This processing time varies from country to country – some take a matter of months and others will take a number of years.

3.5 The E&Y report identified examples of NT's claims processing being slower than the market standard for such work. However, with the exception of the Swiss,

German, Dutch and Norwegian claims the amounts involved were relatively low. We will continue to work with NT to ensure that our claims are processed as quickly as possible.

- 3.6 Swiss claims accounted for 73% (£2,918k) of the value of Lothian Pension Fund claims and 70% (£306k) of the value of Lothian Buses Pension Fund claims as at 31 March 2016. The position for each year's reclaim compared with the position at 31 March 2015 can be summarised as follows:

| Year | Lothian Pension Fund | Lothian Pension Fund | Lothian Buses Pension Fund | Lothian Buses Pension Fund | Comment |
|--------------|----------------------|----------------------|----------------------------|----------------------------|---|
| | 31/3/16 £ | 31/3/15 £ | 31/3/16 £ | 31/3/15 £ | |
| 2011 | - | 79k | | - | Claim paid in 2015/16 |
| 2012 | - | 553k | | 114k | Claim paid in 2015/16 |
| 2013 | - | 812k | | 108k | Claim paid in 2015/16 |
| 2014 | 1,040k | 992k | 125k | 120k | Claim paid in October 2016 |
| 2015 | 1,153k | 642k | 105k | 73k | 2015 claims are expected to be paid during the second quarter of 2017 |
| 2016 | 725k | - | 76k | - | Claim cannot be made until the end of the calendar year |
| Total | 2,918k | 3,078k | 306k | 415k | |

- 3.7 In summary, the claims for 2011, 2012 and 2013 were paid in financial year 2015/2016 and the claims for 2014 were paid in October 2016. This represents a considerable improvement compared to the situation a few years ago.

- 3.8 For Germany the position for the Lothian Pension Fund claims can be summarised as follows;

| Year | Lothian Pension Fund | Lothian Pension Fund | Comment |
|--------------|----------------------|----------------------|--|
| | 31/3/16 £ | 31/3/15 £ | |
| 2014 | 15k | 17k | Due to changes in the certification process required by HMRC the claims for 2014 were not submitted to the German authorities until August 2016. They are expected to be paid during the second quarter of 2017. |
| 2015 | 30k | - | Submitted to the German authorities in August 2016. |
| 2016 | 93k | - | Increase in exposure to German market has increased the amount to claim. Claims currently under preparation. |
| Total | 138k | 17k | |

3.9 For the Netherlands the position for the Lothian Pension Fund claims can be summarised as follows;

| Year | Lothian Pension Fund | Lothian Pension Fund | Comment |
|--------------|----------------------|----------------------|---|
| | 31/3/16 £ | 31/3/15 £ | |
| 2011 | - | 6k | Claim paid during 2015/16. |
| 2013 | 5k | 4k | Claim delayed due to discrepancy at sub custodian. Situation is being investigated. |
| 2014 | - | 23k | Claim paid during 2015/16. |
| 2015 | 145k | 23k | Increase in exposure to Dutch market. Paid October 2016. |
| 2016 | 28k | - | Claim submitted September 2016. |
| Total | 178k | 56k | |

3.10 For Norway the position for the Lothian Pension Fund claims can be summarised as follows;

| Year | Lothian Pension Fund | Lothian Pension Fund | Comment |
|--------------|----------------------|----------------------|---|
| | 31/3/16 £ | 31/3/15 £ | |
| 2014 | 224k | 223k | Similar to the German market, there was a delay in the HMRC certification which resulted in the extended timeframe. Additionally, there was a question raised by the Norwegian authorities in relation to the dividend voucher which NT provided, in February 2016. The pre-2016 reclaims are all pending with the Norwegian Tax Authorities. |
| 2015 | 201k | 18k | See above. |
| 2016 | 21k | - | Claim cannot be made until end of calendar year. |
| Total | 446k | 241k | |

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 2015/16 on Lothian Pension Fund was £2,114k (£2,062k 2014/15); claims paid were £656k (£2,053k 2014/15), leaving a balance to be recovered of £3,999k at 31 March 2016 (£3,937k at 31 March 2015). For Lothian Buses Pension Fund, recoverable tax accrued during 2015/16 was £203k (£190k 2014/15); claims paid were £245k (£34k 2015/16), with the balance of £434k at 31 March 2016 (£476k at 31 March 2015).

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 Pension Board, 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 Appendix 1 – Summary of the findings of the withholding tax benchmarking report

Summary of the Findings of the Withholding Tax Benchmarking Report

| Country | Findings | Conclusions as at Date of Preparation of Report to Pensions Audit Sub-Committee |
|---------|--|---|
| Austria | <p>While the statutory position is 27.5% withholding tax with a 12.5% reclaim allowed under the treaty, Austria does allow for UK pension funds to make full reclaims as a UK pension fund is similar to an Austrian pension fund, which is allowed an exemption.</p> <p>In most instances, the full reclaim appears to be made by Northern Trust and therefore Lothian receives the correct amount. For two dividend distributions however, Northern Trust is showing a 12.5% reclaim instead of a 27.5% reclaim. The amount involved is £16,867.</p> | <p>LPF comment:</p> <p>Query has been raised with NT.</p> <p>NT comment:</p> <p>Under double tax treaty the withholding tax rate can be reduced to 15%. There is also a potential to reclaim to the full exemption rate via reclaim under domestic law. UK pension funds must demonstrate equivalency to an Austrian pension fund. For Lothian NT accrued the full exemption rates for 2012-2015. Due to uncertainty around supporting documentation requirements, for 2016, NT changed the process to accrued at the treaty rate. Following successful repayment at the domestic law rate NT would accrue and process the additional reclaim amount.</p> |
| China | <p>Investments into Chinese entities may be Chinese-listed ("A shares") or foreign listed (e.g. Hong Kong listed H shares). As the dividends shown in the report are denominated in Hong Kong Dollars, we would expect these investments to be in H shares. Hong Kong does not impose withholding tax on dividends. As such, we would expect the further reclaims of £102,086 to be available. This may not be the case if the shares are not, in fact, H shares.</p> | <p>LPF comment:</p> <p>Query has been raised with NT.</p> <p>NT comment:</p> <p>Although Chinese shares can be H-shares, pursuant to Enterprise Income Tax Law in China, issuers may be required to withhold tax on dividend payments to non-resident shareholders. This can result in the withholding of 10% on H-shares.</p> |
| Denmark | <p>While the statutory position is 27% withholding tax with a 12% reclaim allowed under the treaty, Denmark does allow for UK pension funds to make full reclaims as a UK pension fund is similar to a Danish pension fund, which is allowed an exemption.</p> <p>In most instances, the full reclaim appears to be made by Northern Trust and therefore Lothian receives the correct amount. For five dividend</p> | <p>LPF comment:</p> <p>Query has been raised with NT.</p> <p>NT comment:</p> <p>NT would submit reclaims at the Double Tax Treaty rate. Income would be received with 27% WHT and a reclaim would be submitted to recover 12% WHT. There is no process in place</p> |

| Country | Findings | Conclusions as at Date of Preparation of Report to Pensions Audit Sub-Committee |
|--------------------|---|---|
| | <p>distributions however, Northern Trust is showing a 12% reclaim instead of a 27% reclaim. The potential further reclaims amount to £20,647.</p> | <p>on obtain a further reclaim under domestic law.</p> <p>LPF comment:</p> <p>We are looking into the whether there is any merit in procuring a firm of accountants to make an additional claim.</p> |
| France | <p>While the statutory position is 30% withholding tax with a 15% reclaim allowed under the treaty, France does allow for UK pension funds to make full reclaims as a UK pension fund is similar to a French pension fund, which is allowed an exemption.</p> <p>In most instances, the full reclaim appears to be made by Northern Trust and therefore Lothian receives the correct amount. For 38 dividend distributions however, Northern Trust is showing a 15% reclaim instead of a 30% reclaim. The potential further reclaims amount to £64,544.</p> | <p>LPF comment:</p> <p>Query has been raised with NT.</p> <p>NT comment:</p> <p>NT would work to obtain the Double Tax Treaty rate (15% WHT) through either relief at source or reclaim. There is no process in place on obtain a further reclaim under domestic law.</p> <p>LPF comment:</p> <p>We are looking into the whether there is any merit in procuring a firm of accountants to make an additional claim.</p> |
| Germany | <p>While the statutory position is 26.375% withholding tax with a 16.375% reclaim allowed under the treaty, Germany does allow for UK pension funds to make full reclaims as a UK pension fund is similar to a German pension fund, which is allowed an exemption.</p> <p>In most instances, the full reclaim appears to be made by Northern Trust and therefore Lothian receives the correct amount. For 21 equity distributions however, Northern Trust is showing a 16.375% reclaim instead of a 26.375% reclaim. The potential further reclaims amount to £442,669.</p> | <p>LPF comment:</p> <p>Query has been raised with NT.</p> <p>NT comment:</p> <p>NT would submit reclaims at the Double Tax Treaty rate. Income would be received with 26.375% WHT and a reclaim would be submitted to recover 16.375% WHT. There is no process in place on obtain a further reclaim under domestic law.</p> <p>LPF comment:</p> <p>We are looking into the whether there is any merit in procuring a firm of accountants to make an additional claim.</p> |
| Taiwan WHT Rate | <p>The statutory rate in Taiwan is 20%, however a UK pension fund should be able to obtain a 10% withholding rate under the UK-Taiwan treaty.</p> | <p>Query has been raised with NT.</p> <p>NT comment:</p> |

| Country | Findings | Conclusions as at Date of Preparation of Report to Pensions Audit Sub-Committee |
|----------------|--|---|
| | There are a number of entries in the income report where no withholding tax is suffered. These should be investigated further. | Dividends and interest pays at the statutory rate. A local tax advisor would be needed to obtain treaty benefits. |