Pensions Audit Sub Committee

2.00 p.m., Monday, 5 December 2016

EU Tax Claims & Income Recovery

Item number	5.2
Report number	
Executive/routine	
Wards	All

Executive summary

This report summarises activity on EU and other tax claims made on behalf of the Lothian Pension Fund. During the period since the last report, no additional claims have been received and the amount recovered to date remains at £1,370.1k. Progress on the remaining claims is discussed in detail within the report.

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Report

EU Tax Claims & Income Recovery

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

2.1 EU tax claims relate to the recovery of tax deducted from dividend payments prior to receipt or payable tax credits thereon. They relate to a fundamental principle of EU law, that all member states should not discriminate in the application of national taxes between home tax payers and those in other member states in a way that is likely to hinder the free movement of capital.

2.2 The claims can be divided into three main types – Manninen / Foreign Income Dividends (FIDS), Fokus and Manufactured Dividends.

2.3 In addition, the report covers a claim made in the USA in respect of Master Limited Partnerships.

Main report

Claims - Manninen / Foreign Income Dividends (FIDS)

3.1 These claims are against the UK tax authorities. The FIDs claim is based on the UK providing for the repayment of tax credits on UK dividends but not on Foreign Income Dividends ("FIDs") paid by UK companies. The Manninen claim is based upon the non-availability of payable tax credits in relation to foreign dividends.

3.2 The European Court of Justice's ruling in the Manninen tax case in September 2004 opened an avenue for claims for tax credits on EU dividends. Pensions Committee has previously agreed to pursue potential claims.

3.3 Based on the decision in the Manninen case, KPMG's EU Tax Group is undertaking statutory claims on behalf of UK pension funds to claim a repayment of tax credits on FIDs and overseas dividend income in respect of periods

1990/91 to 1997/98. Pension funds have also pursued parallel claims in the High Court.

3.4 The claims are for tax credits and are based on the rate of advance corporation tax in place in respect of the overseas dividends. While the UK tax authorities are disputing the validity of such claims, the estimates show that Lothian Pension Fund could benefit by up to £2.6m from a successful claim. A cost benefit analysis concluded that a claim should be lodged, and this was done on 9 February 2006.

3.5 HMRC has rejected all claims of this nature. As a result, KPMG has appointed a firm of solicitors (Pinsent Masons) to pursue recovery by way of a test case brought with the BT Pension Scheme as the test claimant.

3.6 A chronology of events to date is provided in the table below:

Date	**Event**
March 2011	First-tier Tribunal (FTT) published its judgement on the test case: • Withholding of tax credits on foreign income dividends and overseas dividends (Manninen) was a breach of EU law – the substantive issues. • All but one of the claims were out of time because they were made more than six years after the end of the tax year in which the relevant dividends were received - the out of time issue.
July 2012	Appeal against the FTT judgement was heard by the Upper Tribunal.
February 2013	Upper Tribunal published its judgement on the appeal and supports judgement of the FTT.
April 2013	Upper Tribunal refuses HMRC's request for leave to appeal on the substantive issue and claimants' request on the out of time issue.
June 2013	Court of Appeal approves direct requests to appeal from HMRC and claimants.
November 2013	Court of Appeal advises that a preliminary hearing will be held in December 2013 to decide if any questions related to the case should be referred to the Court of Justice of the European Union (CJEU).
January 2014	Court of Appeal rejects the claimants' appeal on the out of time issue (based on UK domestic law). A further hearing by

	the Court of Appeal has been set for February 2015 to consider HMRC's appeal on the substantive issue and the out of time issue (based on European law). It is possible that the Court of Appeal will refer certain issues to the CJEU at this hearing.
June 2015	The second Court of Appeal hearing took place in June 2015 concerning EU law based "out of time" arguments and the substantive issues.
July 2015	The Court of Appeal handed down its judgement: 1. The original decision on the out of time issue is upheld. 2. On the substantive FIDs issue the Court has decided to refer this to the CJEU. 3. The Court did not determine the substantive Manninen issue because it was found not to be relevant as the claims were out of time. On the FIDs substantive issue the parties agreed the specific questions that will be referred to the CJEU.
August 2015	On the out of time issue an application for permission to appeal was submitted to the Supreme Court directly.
January 2016	The Supreme Court refuses to grant permission to appeal on out of time issue. CJEU acknowledge start of legal process on the substantive issue. Hearing should take place late in 2016 with the judgement likely to be issued within six months afterwards.
October 2016	CJEU hearing was held on 9 November 2016 with the Opinion of the Advocate General likely to follow about three months later.

3.7 The above wording on progress with this claim has been reviewed by Pinsent Masons.

3.8 Fees incurred to date, by Lothian Pension Fund, on these claims amount to £63.4k (£58.2k as at the last update to Committee in December 2015). Assuming that the case is pursued to a final conclusion, total costs for the Fund are capped at £90k. This compares with the claim for £2.6m.

Claims – Fokus Bank

3.9 These claims are against the tax authorities of the EU member states (and Norway) in which the Fund has invested. The basis of the claims is that the tax authorities have applied favourable tax treatment to domestic pension funds that they have denied to pension funds in other member states.

3.10 The Pensions Committee of October 2007 approved making claims under the principle established in the Fokus Bank case. Claims currently estimated at around £3.7m have been made. Progress on the claims is summarised in the table below.

Country	Claim Period From / To	Estimated Amount Claimed	Amount Received	Notes
Completed Claims				
Austria	2006 2010	£83.0k	£83.0k	Claim paid in September 2012.
Netherlands	2003 2006	£440.0k	£440.0k	Claim paid in 2009.
Norway	2004 2010	£278.9k	£278.9k	All claims paid - final instalment received in February 2013 (£73k)
Spain	2004 2009	£568.2k	£568.2k	All claims paid - final instalment received in March 2015 (£102k)
Active Claims				
France	2005 2009	£701.4k [€776.7k]	-	15% tax imposed on all pension funds from 1 January 2009 – so no further claims can be made after that date. In May 2012, the EU Court ruled in the Santander test case that refunds must be paid to investment funds. In February 2016 KPMG submitted a comparability analysis demonstrating that Lothian Pension Fund is in a similar situation to the test claimant. For efficiency purposes our claim is being included in a batch with similar claimants. This has delayed the filing of the documentation with the French Tax Authorities. There is the chance that we could see payment of the claim during 2017.

Country	Claim Period From / To	Estimated Amount Claimed	Amount Received	Notes
Germany	2003 2010 2011 2014	£971.8k [€1,076.0k] £122.3k [€135.5k]	-	In August 2015, following a competitive tender, Deloitte LLP was appointed to make additional claims in respect of the calendar years 2011 to 2014 inclusive. While the principles behind the claims seem to have been accepted by the German tax authorities, they are currently refusing to clarify the procedure that has to be followed to obtain payment of the claims. There have been continuing delays in KPMG appointing a test claimant so that the question of repayment can be decided in the German Courts. The delay is due to German pension funds not being all treated as wholly tax exempt in Germany –resulting in difficulties in making comparisons with UK pension funds. KPMG continues to look for effective ways of progressing the claims of UK pension funds.
Italy	2004 2010	£542.3k [€600.5k]	-	The Italian Tax Authority has taken no action in respect of claims and it seems litigation will be required for a resolution. There has been little appetite amongst claimants to date, to fund a test case. KPMG believe claimants prefer to concentrate efforts on France and Germany before considering Italy.
TOTAL		**£3,707.9k**	**£1,370.1k**	

3.11 Exchange rate movements have had the effect of increasing the value of the unpaid claims since last year's report. Increasing the estimated total amount claimed from £3,207.7k to £3,707.9k.

3.12 Fees incurred to date on these claims amount to £389.7k (£369.4k as at the meeting of December 2015). Costs are higher for the Fokus Bank type claims because of the need to file claims separately in individual EU countries.

Claims – Manufactured Dividends (MODs)

3.13 This claim is against the UK tax authorities. It is based on the fact that manufactured dividend receipts relating to UK shares were not subject to any UK withholding tax but receipts relating to manufactured overseas dividends suffered a UK withholding tax.

3.14 Note that manufactured dividends are dividends created when a security is out on loan at the time the company pays a dividend.

3.15 Claims in respect of manufactured dividends totalling £4,870.6k have been lodged with HMRC on behalf of Lothian Pension Fund

3.16 KPMG has appointed a firm of solicitors (Pinsent Masons) to pursue recovery. A brief chronology of events to date is provided in the table below:

Date	**Event**
March 2013	An initial hearing of the First-tier Tribunal (FTT) took place.
During 2014	Pinsent Masons were in correspondence with HMRC through the course of 2014 and have agreed a statement of facts in order to minimise the fact-finding undertaken by the Tax Tribunal at the hearing itself.
November 2015	The case was heard by the FTT (sitting in London between 2 and 5 November 2015). A decision was reserved by the Tribunal to be handed down at a later date.
July 2016	The FTT concluded that there was a movement of capital, but that the MODs rules applied by HMRC did not amount to a restriction on the movement of capital.
August 2016	The FTT granted the test claimant permission to appeal its decision to the Upper Tribunal.
October 2016	The Upper Tribunal stage commenced.

3.17 The above wording on progress with this claim has been reviewed by Pinsent Masons.

3.18 Fees incurred to date on these claims amount to £146.3k (£116.3k as at the meeting of December 2015). Potential subsequent referrals are estimated to cost £20k for each legal stage.

Claims – Master Limited Partnerships

3.19 This claim is against the US tax authorities. The withholding tax (WHT) audit reported to Committee in December 2014 noted that there were 21 income receipts in the USA that had suffered a tax deduction of 35%. The WHT rate for dividends in the USA is 0%. However, the 35% deductions were in respect income distributions from Master Limited Partnerships.

3.20 Following a competitive tender in the summer of 2015, a KPMG was appointed to make a tax claim in the USA. The value of the claim for the year ended 31

December 2014 was estimated to be around $576,000. However, after detailed research by KPMG, it has been discovered that the WHT deducted from Publicly Traded Partnership Distributions is not recoverable by UK pension funds. As a result this claim cannot be progressed. The investigation work incurred a fee of £4k, given the tax loss to Lothian Pension Fund; it was deemed appropriate to do sufficient research to definitively decide the matter. For investment reasons, Master Limited Partnerships are no longer used by Lothian Pension Fund.

Measures of success

4.1 Success is measured by the amount of tax recovered exceeding the cost of pursuing the claims.

Financial impact

5.1 Tax claims totalling of £11.2m have now been lodged with the relevant tax authorities. Professional fees amounting to £599.4k have been paid to date. As previously agreed by Pensions Committee, it is likely that further legal costs will be incurred in pursuing the claims. However, any legal costs are shared across a pool of fellow claimants and Lothian Pension Fund has the right to cease participation without incurring further costs.

5.2 Currently, claims paid to date exceed the costs incurred by £770.7k. So irrespective of the outcome of the remaining claims Lothian Pension will have accrued a financial benefit. The financial position can be summarised as follows:

Claim Type	Total Claims £'000	Claims Settled £'000	Claims Outstanding £'000	Costs to Date £'000
Manninen	2,626.7	Nil	2,626.7	63.4
Fokus Bank	3,707.9	1,370.1	2,337.8	389.7
Manufactured Dividends	4,870.6	Nil	4,870.6	146.3
	11,205.2	**1,370.1**	**9,835.1**	**599.4**

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	