Pensions Audit Sub Committee

2.00pm, Monday, 11 December 2017

Investment Income Review Cross Border Withholding Tax

Item number	5.5
Report number	
Executive/routine	
Wards	All
Council Commitments	Delivering a Council that works for all

Executive Summary

This report provides information on a benchmarking study prepared by EY 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 EY shows that Northern Trust is generally applying the correct withholding tax rates on investment income. Recovery claims are being processed and reclaims received but EY advise that the time taken seems to be longer than the market standard for refunds. A summary of the opportunities and issues identified is provided.

Report

Investment Income Review Cross Border Withholding Tax

1. Recommendations

Committee is requested to:

1.1 Note the report and highlight any points it would like to raise at the Pensions Committee on 12 December 2017.

2. 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 2016/17 financial year the Pension Funds earned income from companies in 33 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 2016/17 and 2015/16 financial years for both Lothian Pension Fund and Lothian Buses Pension Fund.

Lothian Pension Fund	**2016/17 £**		**2015/16 £**
Brought Forward 1 April	3,998,673.01		3,937,409.41
Recoverable tax accrued during year	3,975,760.09		2,113,859.80
Claims paid during year	(3,771,744.82)		(2,052,596.20)
Carried Forward 31 March	4,202,688.28		3,998,673.01

Lothian Buses Pension Fund	**2016/17 £**		**2015/16 £**
Brought Forward 1 April	433,978.69		476,181.59
Recoverable tax accrued during year	326,214.98		202,692.33
Claims paid during year	(352,918.59)		(244,895.23)
Carried Forward 31 March	407,275.08		433,978.69

2.9 The balance carried forward increased by £204k for Lothian Pension Fund and fell by £27k for Lothian Buses Pension Fund.

2.10 The year-end recoverable tax balances at 31 March 2017 and 31 March 2016, 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 31/3/17 £	Number of Dividends 31/3/17		Reclaim Amount 31/3/16 £	Number of Dividends 31/3/16
Austria	54,505.28	18		38,001.16	16
Belgium	-	-		33.37	1
Canada	-	-		4,526.36	2
Denmark	28,431.85	9		8,280.04	5
France	64,130.39	47		37,744.04	25
Germany	723,567.24	16		138,136.59	21
Israel	-	-		12,598.08	3
Japan	-	-		-	-
Netherlands	175,751.82	20		178,050.13	22
Norway	443,846.94	24		445,730.33	26
Poland	-	-		14,250.66	2
Russian Federation	-	-		-	-
South Africa	-	-		-	-
Spain	18,513.24	4		15,090.80	4
Sweden	340.54	1		326.30	1
Switzerland	2,583,416.00	28		2,918,336.47	46
United Kingdom	110,181.98	4		187,568.68	11
United States	-	-		-	-
Grand Total	4,202,688.28	171		3,998,673.01	185

Lothian Buses Pension Fund	Reclaim Amount 31/3/17 £	Number of Dividends 31/3/17		Reclaim Amount 31/3/16 £	Number of Dividends 31/3/16
Denmark	6,607.61	4		2,414.66	3
France	36,396.33	11		7,190.49	2
Germany	91,675.58	7		19,568.27	4
Italy	-	-		885.75	1
Japan	-	-		-	-
Netherlands	13,414.91	5		14,499.30	5
Norway	60,039.98	15		61,318.63	14
South Africa	1,118.65	1		-	-
Spain	2,584.93	1		2,396.08	1
Switzerland	178,232.03	7		305,725.80	15
United Kingdom	17,205.06	4		19,979.71	5
Grand Total	407,275.08	55		433,978.69	50

2.11 For Lothian Pension Fund, Switzerland accounts for 61% (73% at 31 March 2016) for the total amount receivable and for Lothian Buses Pension Fund the percentage for Switzerland is 44% (70% at 31 March 2016). 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. However, with the change in investment strategy, the Scottish Homes Pension Fund now has direct holdings in equity investments. As a result, the Fund's WHT experience will be included in next year's version of this report.

3. Main report

Benchmarking Study

3.1 Given the complexity and scale of the taxation of investment income, it is important that the Funds' custodian, 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 (EY) has been commissioned to prepare a benchmarking report. EY's remit was:

- Review the withholding tax rates applied by NT and verify these with a database of rates prepared by EY;
- 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 2017);
- 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 potential opportunities and issues. These are summarised in the Appendix to this report. NT has responded to the points raised and the responses have been incorporated in the Appendix.

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 EY 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 61% (£2,583k) of the value of Lothian Pension Fund claims. The amounts due can be summarised as follows:

Year	Lothian Pension Fund	Lothian Pension Fund	Comment
	31/3/17 £	**31/3/16 £**	
2014	-	1,040k	Paid in 2016/17
2015	-	1,153k	Paid in 2016/17
2016	1,630k	725k	Outstanding at 31October 2017 – Claim submitted to sub custodian
2017	953k	-	Claim cannot be made until the end of the calendar year
Total	**2,583k**	**2,918k**	

3.7 The oldest claim outstanding as at 31 March 2017 has been reduced by a complete year's claim compared to 31 March 2016.

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 £	**31/3/16 £**	
2014	-	15k	Paid in 2016/17
2015	-	30k	Paid in 2016/17
2016	621k	93k	Outstanding at 31October 2017 – Claim submitted to sub custodian. Increase in exposure to German market has increased the amount to claim.
2017	103k	-	Current NT status: Market issue. Awaiting further comment from NT.
Total	**724k**	**138k**	

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
	31/3/17	**31/3/16**	

Year	Lothian Pension Fund	Lothian Pension Fund	Comment
	£	£	
2013	5k	5k	Paid 2017/18
2015	-	145k	Paid 2016/17.
2016	143k	28k	Paid 2017/18
2017	28k	-	NT Status: Reclaim submitted to sub custodian
Total	176k	178k	

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
	31/3/17 £	31/3/16 £	
2014	-	224k	Paid 2016/17
2015	223k	201k	Paid 2017/18
2016	221k	21k	£131k paid 2017/18 to date
Total	**444k**	**446k**	

4. Measures of success

4.1 Minimising exposure to tax on investment income.

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

5. Financial impact

5.1 The recoverable tax accrued during 2016/17 on Lothian Pension Fund was £3,976k (£2,114k 2015/16); claims paid were £3,772k (£2,053k 2015/16), leaving a balance to be recovered of £4,203k at 31 March 2017 (£3,999k at 31 March 2016).

5.2 For Lothian Buses Pension Fund, recoverable tax accrued during 2016/17 was £326k (£203k 2015/16); claims paid were £353k (£245k 2015/16), with the balance of £407k at 31 March 2017 (£434k at 31 March 2016).

6. Risk, policy, compliance and governance impact

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

7. Equalities impact

7.1 There are no equalities implications as a result of this report.

8. Sustainability impact

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

9. Consultation and engagement

9.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the Fund and they are invited to comment on the relevant matters at Committee meetings.

10. Background reading/external references

10.1 None

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11. Appendices

Appendix 1 – Summary of the findings of the withholding tax benchmarking report

Pensions Audit Sub Committee Appendix 1

11 December 2017

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**
Canada	Summary: Potential claim for £41,415 identified. Detail: 24 dividends have been subject to a 25% withholding tax, whilst a further 11 dividends have been subject to a 15% withholding tax. Those subject to 25%, are held at the dividend headline rate, and those subject to 15% are held at the treaty rate. However, pension funds should be tax-exempt with respect to their investment income and therefore a full reclaim may be possible. Northern Trust have advised that in 2016, your documentation did not cover Trust Income, which would explain why there have been amounts withheld. As the total amount available for reclaim is CAD 68,875 (£41,415), it may be worth considering applying for this. As this has been flagged by Northern Trust as not processed due to Lothian's documentation not covering Trust Income.	**LPF comment:** Trust income refers to the income from the Canadian form of unit trusts. **NT comment:** After reviewing the case further, and taking into consideration our experience in the market (NT is a withholding tax agent in Canada), it is NT's view that UK Pension Funds are not able to obtain the full withholding tax on Canadian TRUST INCOME. If EY believes that the full exemption can be applied to LPF on Canadian TRUST INCOME, NT can provide the necessary tax vouchers to allow EY to lodge the tax reclaims or NT could investigate further on the reclaim possibility provided that EY shares the necessary information to sustain their comments around the eligibility. Please also note that Canadian income not referring to TRUST INCOME was correctly paid at pay date. **LPF Conclusion:** EY have now confirmed that they agree with NT's second response that the correct withholding has been applied in this case based on the type of income. No further action is now required.
Germany	Summary: Confirmation needed on claim for £996,710 Detail: 26 dividends have been subject to a 26.375% withholding tax rate. This is the dividend headline rate. The treaty rate is 10%. Northern Trust are not treating any of these as recoverable.	**LPF comment:** We have checked the data and confirm the finding. However, a review of the NT claim status report would appear to show that claims have been lodged. Query has been raised with NT to confirm that the claims have been made.

Country	Findings	Conclusions as at Date of Preparation of Report to Pensions Audit Sub-Committee
	We would have expected Northern Trust to access the treaty rate on the 26 dividends. As Lothian has suffered a higher rate, the total tax leakage that could have been avoided is EUR 1,119,145 (£996,710). From our discussions with Northern Trust so far, it is not clear if these are being recovered and this should be monitored.	**NT comment:** Germany is a reclaim market so the market statutory rate (26.375%) will always be reflected at pay date. NT is accruing all these payments and processing the claims with our sub-custodian. For 2016 pay dates, the claims have been lodged or are being reviewed with our sub-custodian. For 2017 pay dates, the claims are currently on hold due to new requirements but NT expects to start lodging it in 2018. For pay dates between 2011 and 2015, all the claims have paid. **LPF Conclusion**: Correct treatment has been applied.
Italy	Summary: Confirmation needed on claim for £113,294 Detail: Eight dividends have been subject to a 26% withholding tax, whilst a further 4 dividends have been subject to an 11% withholding tax. Those subject to 26%, are withheld at the dividend headline rate, and those subject to 11% are withheld at the treaty rate. Northern Trust are not treating any of these as recoverable. We would have expected Northern Trust to access the treaty rate on the eight dividends that have suffered 26% withholding tax. As Lothian has suffered a higher rate, the total tax leakage that could have been avoided is EUR 127,211 (£113,294).	**LPF comment:** We have checked the data and confirm the finding. A check of the NT claim status report has not confirmed the status of the claims. Query has been raised with NT to confirm that the claims have been made. **NT comment:** Italy is a relief at source (RAS) market and the reclaim process is quite difficult (in terms of requirements and also the fact that the Italian Tax Authorities usually take more than 10 years to issue the refunds). For this reason, NT does not offer a reclaim service in the market. Nevertheless, the RAS service is offered and LPF obtains the treaty rates (11%) at pay date. In case RAS is missed, NT is able to offer a quick adjustment process (we have 4 months to receive the documents and request the tax adjustments). All the payments that EY are referring as outstanding were actually subject to this procedure and were already paid to LPF. **LPF Conclusion**: Correct treatment has been applied.
Netherlands	Summary: Confirmation needed on claim for £254,150 Detail:	**LPF comment:** We have checked the data and confirm the finding. However, a check of the NT claim status report would appear to show that claims have been made.

Country	Findings	Conclusions as at Date of Preparation of Report to Pensions Audit Sub-Committee
	41 dividends have suffered a 15% withholding tax, which is the headline dividend rate. There is a domestic provision exempting tax for non-resident tax-exempt pension funds. Northern Trust are only treating ten of these withholdings as recoverable. We would have expected Northern Trust to access the treaty exemption on the remaining 31 dividends. The total tax leakage that could have been avoided is EUR 285,369 (£254,150).	Query has been raised with NT to confirm that the claims have been made. **NT comment:** Netherlands is a reclaim market so the market statutory rate (15 %) will always be reflected at pay date. NT is accruing all these payments and processing the claims with our sub-custodian, for the full withholding tax exemption. For pay dates between 2011 and 2016, all the claims have been paid. For 2017 payments, 3 claims have been paid and 19 are being lodged. **LPF Conclusion**: Correct treatment has been applied.
Taiwan WHT Rate	Summary: Opportunity for a tax claim of £758,322. Detail: The statutory rate in Taiwan is 20%, however a UK pension fund should be able to obtain a full reclaim as they are generally tax exempt. 8 dividends have been held at the statutory rate and are eligible for a reclaim of TWD 30,114,864.77 (£758,322). Due to the complexities of the Taiwanese market, Northern Trust will not offer a reclaim service. EY is able to support this and to assist the funds in obtaining treaty relief at source going forward.	**LPF comment:** A claim was submitted to reclaim the WHT suffered in excess of the UK-Taiwan Double Tax Treaty in August 2010 for the years 2005 to 2009 for 23,821,000 TWD. A top up claim was submitted in 2013 for 9,742,000 TWD. These claims have now concluded. Therefore, it should be possible to make claims from 2013 onwards. Under procurement regulations it will be necessary to conduct a competitive tender for this reclaim work.
Sundry EU Countries	Summary: EY have suggested that there is the possibility of making additional Fokus Bank type claims in respect of the following countries. Detail: **Denmark** We note that UK pension funds should be exempt from tax on Danish dividends under European Court of Justice (ECJ) principals) and therefore should be able to make a full reclaim DKK 333,544 (£39,892). **France** We note that UK pension funds should be exempt from tax on French dividends under European Court of Justice (ECJ) principals) and	**LPF comment:** The status of previous Fokus Bank type claims is the subject of a separate report to the Pensions Audit Sub Committee. The additional claims suggested opposite, have been discussed with EY. Even without considering the likelihood of claims be paid, EY have agreed that it would not be cost effective to progress claims for Denmark, Portugal and Sweden. Italy, has been discounted as the prospect of payment is viewed as remote.

Country	Findings	Conclusions as at Date of Preparation of Report to Pensions Audit Sub-Committee
	therefore should be able to make a full reclaim EUR 251,994 (£224,425) (this is exclusive of the 30% withholding rates not already recovered). We are aware that we have discussed this with you since the last report, and that you may not choose to pursue this path, although it may be worth discussing further still. **Germany** We note that UK pension funds should be exempt from tax on French dividends under European Court of Justice (ECJ) principals) and therefore should be able to make a full reclaim EUR 683,447 (£619,646). **Italy** We note that UK pension funds are tax-exempt with respect to their investment income and therefore should be able to make a full reclaim EUR 150,553 (£135,772). **Portugal** We note that UK pension funds should be exempt from tax on Portugal dividends under European Court of Justice (ECJ) principals) and therefore should be able to make a full reclaim EUR 52,180 (£56,760). **Spain** We note that UK pension funds should be exempt from tax on Spanish dividends under European Court of Justice (ECJ) principals) and therefore should be able to make a full reclaim EUR 122,731 (£109,280). **Sweden** We note that UK pension funds should be exempt from tax on Swedish dividends under European Court of Justice (ECJ) principals) and therefore should be able to make a full reclaim SEK 445,951 (£40,983).	NT's comment on Spain is that LFP is already receiving the full withholding tax refunds via NT. As a result of last year's report from EY we discussed the possibility of additional claims in respect of Germany and France with EY and other potential providers. Only EY was prepared to make additional claims in France and on that basis LPF has not progressed that option. There was more general support for German claims and on that basis a Quick Quote procurement was undertaken with 3 potential providers. EY had the winning bid. However, Officers have decided that, based on an assessment of the cost and the perceived likelihood of the claims ultimately being paid, these additional claims should not be made.