Pensions Audit Sub Committee

10.00 a.m., Tuesday, 15 December 2015

Investment Income Review Cross Border Withholding Tax

Item number	5.7
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. There is positive news on the payment of claims by the Fund's largest debtor – Switzerland.

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Report

Investment Income Review Cross Border Withholding Tax

Recommendations

1.1 That Committee invites 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 16 December 2015.

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 2014/15 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.

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 2014/15 and 2013/14 financial years for both Lothian Pension Fund and Lothian Buses Pension Fund.

Lothian Pension Fund	**2014/15 £**		**2013/14 £**
Brought Forward 1 April	2,531,042.23		1,842,564.05
Recoverable tax accrued during year	2,062,513.96		1,751,330.62
Claims paid during year	(656,146.78)		(1,062,852.44)
Carried Forward 31 March	3,937,409.41		2,531,042.23

Lothian Buses Pension Fund	**2014/15 £**		**2013/14 £**
Brought Forward 1 April	320,259.30		286,235.33
Recoverable tax accrued during year	189,959.71		168,919.59
Claims paid during year	(34,037.42)		(134,895.62)
Carried Forward 31 March	476,181.59		320,259.30

2.9 In the case of both funds there have been increases in the amount of recoverable tax accruing during the year. However, in both cases the claims paid have fallen considerably due to delays experienced with the Swiss claims. 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.

2.10 The year end recoverable tax balances at 31 March 2015 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 31/3/15 £	Number of Dividends 31/3/15		Reclaim Amount 31/3/14 £	Number of Dividends 31/3/14
Austria	34,795.27	31		23,663.09	31
Belgium	30.45	1		41,106.58	5
Canada	-	-		15,117.68	7
Denmark	1,041.69	3		979.88	1
France	6,279.24	4		3,196.29	3
Germany	17,720.39	10		11,958.49	4
Israel	1,613.34	1		-	-
Japan	-	-		24,188.83	10
Netherlands	55,868.52	9		34,911.14	6
Norway	240,655.91	12		115,841.23	10
Poland	13,544.28	2		10,934.80	1
Russian Federation	23,301.70	1		-	-
South Africa	532.56	1		-	-
Spain	245,452.03	67		-	-
Switzerland	3,078,224.96	77		2,100,482.41	61
United Kingdom	216,945.77	17		146,100.43	14
United States	1,403.30	2		2,561.38	3
Grand Total	**3,937,409.41**	**238**		**2,531,042.23**	**156**

Lothian Buses Pension Fund	Reclaim Amount 31/3/15 £	Number of Dividends 31/3/15		Reclaim Amount 31/3/14 £	Number of Dividends 31/3/14
Canada	-	-		783.68	4
Denmark	91.72	1		243.32	1
Germany	4,302.45	2		3,194.38	2
Japan	4,343.42	1		499.52	1
Netherlands	5,051.26	2		419.08	1
Norway	34,592.56	7		7,025.68	4
Spain	2,186.45	1		-	-
Switzerland	414,841.70	18		307,589.08	12
United Kingdom	10,772.03	3		504.56	1
Grand Total	**476,181.59**	**35**		**320,259.30**	**26**

2.11 For Lothian Pension Fund, Switzerland accounts for 78% (83% at 31 March 2014) for the total amount receivable and for Lothian Buses Pension Fund the percentage for Switzerland is 87% (96% at 31 March 2014). 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 claims are discussed in more detail later on 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, 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 2015);
- Review the withholding tax reclaims that have already 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 small number of opportunities and issues. These are summarised in the Appendix to this report, including responses from NT to the points raised.

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 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.

3.5 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.

3.6 KPMG have again highlighted delay in dealing with the Swiss claims which accounted for 78% (£3,078k) of the value of Lothian Pension Fund claims and 87% (£415k) of the value of Lothian Buses Pension Fund claims as at 31 March 2015. The position for each year's reclaim can be summarised as follows, more details can be Appendix to this report :

Year	**Lothian Pension Fund Amt at 31/3/15** **£**	**Lothian Buses Pension Fund Amt at 31/3/15** **£**	**Comment**
2011	79k	-	Claim is responsibility of the custodian at the time dividends were received. Citibank have confirmed that the claim is still active and should be paid in due course.
2012	553k	114k	2012 claims were originally sent to the Swiss tax authority on 25 October 2013. After various queries raised by the Swiss tax authority they issued a formal rejection notice in July 2015, which meant that NT needed to resubmit the forms. Resubmission coincided with new procedures and delays caused by the claim certification required from HMRC. This should be completed in the next few weeks. Following which the Swiss tax authority should pay the claim within 6 to 8 weeks.
2013	812k	108k	This year's claim was certified by HMRC before the change of procedure and was not rejected by the Swiss. The claims for both Lothian Pension Fund and Lothian Buses Pension Fund were paid in September 2015.
2014	992k	120k	Claims have not yet been submitted by NT due to the HMRC certification issue mentioned above. However the certification issue is now resolved and NT are due to submit these claims in the next two weeks (from 6 November 2015).
2015	642k	73k	Claim cannot be made until the end of the calendar year.
Total	3,078k	415k	

3.7 In summary, despite the delays caused by HMRC and the Swiss Tax Authorities, the claim for 2013 was paid in September 2015 and this should set a precedence for the other claims to be paid in due course.

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 2014/15 on Lothian Pension Fund was £2,062k (£1,751k 2013/14); claims paid were £656k (£1,063k 2013/14), leaving a balance to be recovered of £3,937k at 31 March 2015 (£2,531k at 31 March 2014). For Lothian Buses Pension Fund, recoverable tax accrued during 2014/15 was £190k (£169k 2013/14); claims paid were £34k (£135k 2013/14), with the balance of £476k at 31 March 2015 (£320k at 31 March 2014).

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

Alastair D Maclean

Chief Operating Officer

Deputy Chief Executive

Contact: Esmond Hamilton, Financial Controller

E-mail: esmond.hamilton@edinburgh.gov.uk | Tel: 0131 469 3521

Links

Coalition pledges	
Council outcomes	CO26 - The Council engages with stakeholders and works in partnerships to improve services and deliver agreed
Single Outcome Agreement	
Appendices	Appendix 1 - Summary of the findings of the withholding tax benchmarking report

Pensions Audit Sub Committee Appendix 1

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 11 dividends have been subjected to WHT at rates from 9.49% 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$37,224 (£17,394). We recommend that you raise this with your custodian.	NT comment: Lothian Pension Fund had an Australian Ruling in place for superannuation fund exemption under domestic law which expired June 2015. The exemption granted covered withholding tax on interest and dividends income only. This would not cover property income distributions where withholding tax can be applied. The renewal of the Private Ruling is currently pending, and Lothian can obtain tax relief from the point of the expired private ruling to when the new one is issued by way of reclaim. LPF comment: As pointed out by NT, some of the dividends were from a property investment company. NT has confirmed that they will make and reclaims necessary pending the granting of the Private Ruling.
Belgium WHT Rate	LPF should be eligible for a 0% rate of WHT on Belgian source dividends. 6 dividends have been taxed at a rate of 25% which is the standard domestic rate of WHT. It is unclear if a reclaim has been made in respect of these dividends. The potential reclaim available is €77,568 (£55,406). We recommend that you raise this with your custodian.	NT comment: Lothian Pension Fund currently receives relief at source in Belgium following submission of the Annex 26 form in February 2015. Prior to the documentation being in place tax was withheld on dividend pay date. Northern Trust would pursue reclaims where Relief at Source was not obtained. Also certain paying agents within the market are ‘black listed’. In this case, the sub custodian will process the dividend as a quick reclaim rather than applying relief at source.
Denmark WHT Rate	Under the Denmark UK Double Tax Treaty, a UK resident pension fund should be entitled to a reduced WHT rate of 15%. NT has applied WHT at rates of either 0% or 27%. The 27% rate is the standard domestic rate and we would expect reclaims to be made by NT and it appears that this	NT comment: Denmark is a reclaim market. Tax is withheld on pay date at 27% and Northern Trust will apply for a reclaim under tax treaty to reduce the rate to 15%. It is possible for certain dividends to pay

Country	Findings	Conclusions as at Date of Report to Pensions Audit Sub-Committee
	has been the case. It is unclear if the income amounts which appear to have been paid gross relate to previous reclaims. It is recommended that you confirm this with your custodian.	gross.
France WHT Rate	The dividend income from France has generally suffered 0%, 15% or 30%. Even across individual dividends there appear to be different rates applied. The correct rate for a UK resident pension fund is 15%. The differences may have arisen as both relief at source and reclaims are available in France and reclaims may be being shown as gross income. There are 167 income events which total over €5 million, therefore, this matter should be investigated with the custodian as soon as possible.	NT comment: NT would pursue a reduced withholding tax rate in France to 15%. The method to obtain the reduced rate would be either at source or via reclaim. Relief at source can be obtained on an annual basis with the submission of the Form 5000, certified by HMRC. This was in place in 2014. However in 2015 this was not obtained until June. This was due to a change in procedure at HMRC which resulted in delays in the certification process. Any prior withholding at 30% will be pursed via reclaim.
Germany WHT Rate	As with France, the data provided shows income paid either gross or at the standard rate of 26.375%. As Germany is a reclaim market, this may be that reclaims have been shown as gross income. We are aware that NT are making reclaims in Germany down to the correct treaty rate of 10% so this may not be an issue but we recommend that you discuss this with your custodian.	NT comment: Lothian Pension Fund can obtain a reduced rate in Germany to 10% withholding tax which can only be received via reclaim. On pay date the dividends would be received less 26.375% withholding tax. A reclaim is then accrued to obtain the remaining 16.375%.
Israel WHT Rate	The standard domestic rate of WHT in Israel is 25%. NT appears to be applying the rate under the Israel UK Double Tax Treaty of 15% to the income from the Teva Pharmaceutical ADRs. 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.	NT comment: These are related to ADR dividends which were received with the maximum tax rate applied. This is based on an allocation from DTC who specified the rate as 15%.
Italy WHT Rate	Italian source dividends should be taxed at a preferential domestic rate of 11% when paid to a UK resident pension fund. Italian income is being taxed at a variety of rates including 4 out of the 26 dividends being taxed at 11%. Given the variety of rates suffered and the difficulty in obtaining reclaims in Italy, we recommend that you raise this with your custodian.	NT comment: Lothian Pension Fund can obtain a reduced rate to 11% WHT. This is dependent upon receipt of a specifically worded Certificate of Residency from HMRC. This has been received for Lothian. For current year reclaims, it is common for divided to pay at the statutory rate of 26%. The dividend will then be adjusted to the favorable

Country	Findings	Conclusions as at Date of Report to Pensions Audit Sub-Committee
		rate up four months after pay date.
Korea WHT Rate	Two Korean dividends have suffered WHT at the standard domestic rate of 22%. LPF is entitled to a reduced rate of 15% under the Korean / UK Treaty. The potential leakage in this case is approximately US$ 1,878 (£1,219).	NT comment: A reduced rate of 15% can be obtained in Korea for Lothian Pension Fund. On non domestically held Korea securities (GDRs/ADRs) it is not possible to obtain relief at source.
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$10,380 (£6,740). We recommend that you raise this with your custodian, however as these amounts relate to ADRs it may be difficult to recover this tax.	NT comment: Lothian Pension Fund would receive dividend at the statutory rate of 30%. Although there is a potential reduced rate under tax treaty, a local tax advisor is required in order to obtain treaty benefits. NT is not able to offer this service in the Philippines. LPF comment: We have looked into the possibility of appointing a local tax adviser but this was not cost effective with the current low level of dividend income.
Poland WHT Rate	One dividend in Poland has suffered the standard domestic rate of 19%. The potential tax leakage is PLN 8,394 (£1,410), therefore we recommend that you raise this with your custodian.	NT comment: Under Polish domestic law it is possible to obtain exemption which Lothian currently receives. The exemption was obtained following the submission of market documentation. Withholding tax received prior to exemption being in place can be reclaimed by Northern Trust. One further document has been identified as required, which is a Declaration. We will send this out to you for completion shortly, once generated.
Russia WHT Rate	LPF has received most dividends at the correct WHT rate of 15%, however 5 were paid at 10%. This reduced rate is provided for under the Russia/UK Treaty, however, as the Treaty contains a subject to tax clause LPF should not be entitled to this rate. In addition, several dividends appear to have been paid gross. We recommend that we raise this with your custodian.	NT comment: The withholding relates to Russia ADRs. Treaty rates are applied based on residency disclosure of underlying holders which was stated at 10%.
Sweden WHT Rate	Swedish dividends should suffer WHT at a rate of 5%. It appears that a number of the dividends have been paid gross. The potential under withholding is	NT comment: The reduced rate payments in questions were

Country	Findings	Conclusions as at Date of Report to Pensions Audit Sub-Committee
	SEK 83,022 (£6,303), therefore we recommend that you discuss this with your custodian.	related to manufactured income payments for shares on loan. The income will be received inclusive of any potential reclaim entitlement which is why there had been only 5% WHT deduced.
Switzerland Reclaims	Numerous Swiss reclaims have been outstanding for longer than the expected timeframe. We are aware that Switzerland only allows 1 reclaim 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.	NT comment: 2012 claims were originally sent to the Swiss tax authority on 25th October 2013. In late 2013 the Swiss tax authority issued a letter requesting further information to support the reclaims. This request was part of a wider trend whereby the Swiss tax authority sought further information for reclaims on behalf of UK pension funds. Northern Trust provided the data required but received a second letter with additional questions. Northern Trust submitted a response for the second letter. This was not received by the Swiss tax authority within the desired timeframe. In July 2015 the Swiss tax authority provided a formal rejection notice which meant that Northern needed to recomplete the forms for the 2012 claims. Northern complied the 2012 reclaims again and sent them to the HMRC for certification as per standard process. Further delays were experienced in the certification of the documents from the HMRC. At the start of 2015 HMRC introduced a new procedure to obtain certification on reclaims. The new procedure allowed for the certification of 2015 reclaims. However it created a market wide issue as a process had yet to be established by HMRC to allow for certification of reclaim forms prior to 2015. This was an industry wide issue effecting all UK pension funds. Through the British Bankers Association, Northern have been lobbying the HRMC and a solution has now been agreed to obtain the required historic certification. We anticipate that Lothians certified forms will be with us in the coming weeks so that the 2012 claims can be submitted to the Swiss tax authority. Once submitted we expect the reclaims to be settled within 6/8 weeks. During the period of initial submission to

Country	Findings	Conclusions as at Date of Report to Pensions Audit Sub-Committee
		now the claims have been protected against statue. 2013 claims were not formally rejected, and answers to subsequent questions were provided without new forms needed. The original 2013 submission was certified, therefore was not delayed due the HMRC issue mentioned above. We have since received the funds. 2014 claims have not yet been submitted due to the HMRC certification issue mentioned above. However the certification issue is now resolved and Northern are due to submit these claims in the next two weeks.
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 121,614 (£2,434).	NT comment: Although a reduced tax rate may be possible under double tax treaty, Northern Trust is unable to support the reclaim process. This is due to the requirement of a local agent in the market. Dividend in the market will be received with 20% WHT.