

Pensions Audit Sub Committee

2.00pm, Tuesday, 11 December 2018

Investment Income Review Cross Border Withholding Tax

Item number	5.3
Report number	
Executive/routine	
Wards	All
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Executive Summary

This report provides information on a benchmarking study prepared by Deloitte into the effectiveness of the procedures in place to manage the tax exposure on the investment income of Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund.

The benchmarking report prepared by Deloitte shows that Northern Trust is generally applying the correct withholding tax rates on investment income. Recovery claims are being processed and reclaims received but Deloitte advise that the time taken seems to be longer than the market standard for refunds (particularly for Switzerland and Germany). A summary of the opportunities and issues identified is provided.

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 2018.

2. Background

The Taxation Environment

- 2.1 Lothian Pension Fund (LPF), Lothian Buses Pension Fund (LBPF) and Scottish Homes Pension Fund (SHPF) 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 2017/18 financial year the Pension Funds earned income from companies in 32 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

- 2.8 The tables below show the movement in the reclaimable tax balances during the 2017/18 and 2016/17 financial years for LPF, LBPF and SHPF.

Lothian Pension Fund	2017/18 £	2016/17 £
Brought Forward 1 April	4,202,688.28	3,998,673.01
Recoverable tax accrued during year	4,013,549.79	3,975,760.09
Claims paid during year	(1,081,720.51)	(3,771,744.82)
Carried Forward 31 March	7,134,517.56	4,202,688.28

Lothian Buses Pension Fund	2017/18 £	2016/17 £
Brought Forward 1 April	407,275.08	433,978.69
Recoverable tax accrued during year	244,662.28	326,214.98
Claims paid during year	(126,709.75)	(352,918.59)
Carried Forward 31 March	525,227.61	407,275.08

Scottish Homes Pension Fund	2017/18 £	2016/17 £
Brought Forward 1 April	-	-
Recoverable tax accrued during year	46,229.12	-
Claims paid during year	(1,406.28)	-
Carried Forward 31 March	44,822.84	-

- 2.9 The balance carried forward increased by £2,932k for LPF, increased by £118k for LBPF and 2017/18 was the first year for SHPF.
- 2.10 The year-end recoverable tax balances at 31 March 2018 and 31 March 2017, broken-down by country, are provided for each of the Funds in the tables below.

Lothian Pension Fund	Reclaim Amount 31/3/18 £	Number of Dividends 31/3/18	Reclaim Amount 31/3/17 £	Number of Dividends 31/3/17
Austria	55,867.68	18	54,505.28	18
Denmark	60,061.61	15	28,431.85	9
France	152,254.73	14	64,130.39	47
Germany	1,648,577.42	34	723,567.24	16
Netherlands	273,002.25	19	175,751.82	20
Norway	296,524.33	10	443,846.94	24
Spain	2048.54	1	18,513.24	4
Sweden	-	-	340.54	1
Switzerland	4,455,400.72	50	2,583,419.00	28
United Kingdom*	190,780.28	8	110,181.98	4
Grand Total	7,134,517.56	169	4,202,688.28	171

Lothian Buses Pension Fund	Reclaim Amount 31/3/18 £	Number of Dividends 31/3/18	Reclaim Amount 31/3/17 £	Number of Dividends 31/3/17
Denmark	10,130.12	6	6,607.61	4
France	1,931.31	2	36,396.33	11
Germany	172,932.27	13	91,675.58	7
Netherlands	18,836.98	5	13,414.91	5
Norway	46,745.97	12	60,039.98	15
South Africa	-	-	1,118.65	1
Spain	-	-	2,584.93	1
Switzerland	257,558.27	11	178,232.03	7
United Kingdom*	17,092.69	4	17,205.06	4
Grand Total	525,227.61	53	407,275.08	55

Scottish Homes Pension Fund	Reclaim Amount 31/3/18 £	Number of Dividends 31/3/18	Reclaim Amount 31/3/17 £	Number of Dividends 31/3/17
Canada	3,702.48	8	-	-
France	9,580.77	3	-	-
Germany	12,124.28	4	-	-
Japan	1,380.31	1	-	-
Netherlands	2,361.45	4	-	-
Norway	4,634.87	6	-	-
Switzerland	8,401.98	2	-	-
United Kingdom*	2,636.70	4	-	-
Grand Total	44,822.84	32	-	-

* Relates to Royal Dutch Shell dividends.

- 2.11 SHPF was mainly invested in pooled funds, so there was no requirement to recover income tax as this was organised by the pooled fund manager. However, with a change in investment strategy, the Scottish Homes Pension Fund had direct holdings in equity investments during the period March 2017 to March 2018. An Index Linked Gilts strategy was adopted in March 2018. As a result, SHPF had some outstanding withholding tax claims at 31 March 2018.
- 2.12 For LPF, Switzerland accounts for 62% (61% at 31 March 2017) for the total amount receivable, for LBPF 49% (44% at 31 March 2017), and for the Scottish Homes Pension Fund 19%. 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.
- 2.13 The Swiss, German, Dutch, Norwegian and French claims are analysed in more detail later in 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, Deloitte has been commissioned to prepare a benchmarking report. The remit was to carry out a review of the WHT suffered for the period 1 August 2017 to 31 July 2018. Deloitte have also been asked to review the timeliness of the WHT reclaims made by the custodian in respect of this period.

Findings – WHT Rates Applied

- 3.3 The study concluded that: "In general, optimal WHT rates appear to have been achieved by the Fund for the majority of dividend distributions received, subject to a few exceptions." However, they have identified a number of potential opportunities and issues. These are summarised in the Appendix to this report. NT has been asked to respond to the points raised and these responses have been included 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 Deloitte 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. The responses of NT to various matters identified have been summarised below. We will continue to work with NT to ensure that our claims are processed as quickly as possible.

3.6 Swiss claims accounted for 62% (£4,455k) of the value of Lothian Pension Fund claims. The amounts due can be summarised as follows:

Year	Lothian Pension Fund	Lothian Pension Fund	Lothian Pension Fund	Comment
	31/10/18 £	31/3/18 £	31/3/17 £	
2016	-	1,519k	1,630k	Paid in 2018/19
2017	2,132k	2,040k	953k	NT status at 31 October 2018: “Documentation Required”. This refers to a NT specific documentation status. There is no requirement for action from LPF.
2018	2,037k	896k	-	Claim cannot be made until the end of the calendar year.
Total	4,169k	4,455k	2,583k	

3.7 The reason for the increase in the balance for the Swiss claims is the 2016 claim not being paid until the 2018/19 financial year. The factors accounting for the delay have been queried with NT.

3.8 NT has stated that the 2016 reclaims were submitted in 2017 and received in 2018 which is within the expected reclaims cycle. Overall in Q1 2017 the Swiss tax authorities have implemented a new payment system which has resulted in delays to the overall processing timeframes from that point.

3.9 For Germany, the position for the LPF claims can be summarised as follows:

Year	Lothian Pension Fund	Lothian Pension Fund	Lothian Pension Fund	Comment
	31/10/18 £	31/3/18 £	31/3/17 £	
2016	643k	636k	621k	NT status at 31 October 2018: “Market Issue”
2017	903k	893k	103k	NT status at 31 October 2018: “Market Issue”

Year	Lothian Pension Fund	Lothian Pension Fund	Lothian Pension Fund	Comment
2018	1,073k	120k	-	NT status at 31 October 2018: "Market Issue"
Total	2,619k	1,649k	724k	

3.10 The reason for the increase in the balance for the German claims is the 2016 claim not being paid to date. NT has stated that in 2018 a post submission enquiry was received from the German Tax Authority requesting transaction information. This can be sourced internally by NT. Such requests were prevalent within the market around 5 years ago but we now have seen them arise on an ad-hoc basis. In addition, in 2017 German domestic tax law introduced an investment holding period of 45 days before and after ex-dividend date which has impacted UK pension funds. As a result, NT have been implementing enhancements to their system to appropriately capture and accrue the reclaims. This is expected to be completed in Q4 2018. This is why the reclaims were assigned a "Market Issue" status.

3.11 For the Netherlands, the position for the LPF claims can be summarised as follows:

Year	Lothian Pension Fund	Lothian Pension Fund	Lothian Pension Fund	Comment
	31/10/18	31/3/18	31/3/17	
		£	£	
2013		-	5k	Paid 2017/18
2016		-	143k	Paid 2017/18
2017	33k	241k	28k	Paid 2018/19
2018	86k	32k	-	Too early to claim
Total	119k	273k	176k	

3.12 The reason for the increase in the balance for the Netherlands claims is the increase in withholding tax for 2017 compared to previous years. The claims are being paid in-line with previous experience.

3.13 For Norway, the position for the LPF claims can be summarised as follows:

Year	Lothian Pension Fund	Lothian Pension Fund	Lothian Pension Fund	Comment
	31/10/18	31/3/18	31/3/17	
	£	£	£	
2015		-	223k	Paid 2017/18
2016	91k	89k	221k	Part payment in 2017/18
2017	195k	190k	-	NT status at 31 October 2018: "Claim Submitted"
2018	102k	18k	-	Too early to claim

Year	Lothian Pension Fund	Lothian Pension Fund	Lothian Pension Fund	Comment
Total	388k	297k	444k	

3.14 The reason for the decrease in the balance for Norwegian claims is a reduction in the amount of withholding tax experienced compared to the previous year.

3.15 For France, the position for the LPF claims can be summarised as follows:

Year	Lothian Pension Fund	Lothian Pension Fund	Lothian Pension Fund	Comment
	31/10/18 £	31/3/18 £	31/3/17 £	
2015		-	33k	Paid 2017/18
2016	-	-	30k	Paid 2017/18
2017	1k	151k	1k	Paid 2018/19
2018	2k	1k	-	Too early to claim
Total	3k	152k	64k	

3.16 The reason for the increase in the balance for the French claims is an increase in the amount of withholding tax experienced. The claim was paid by 31 October 2018.

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 financial impact of the withhold tax claims is described in section 2.8 of this report.

6. Risk, policy, compliance and governance impact

- 6.1 There is the potential risk of failure to recover the correct amount of withholding tax. The objective of the annual benchmarking report is to minimise this risk.
- 6.2 There are no 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

11 December 2018

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
Germany	<p>Summary: Approximately £707,785 may be reclaimable through EU law reclaims. Deloitte can provide support in this regard if needed. We would note this may be a long process, as Germany are not currently processing claims.</p>	<p>LPF Conclusion: As discussed in the separate report to the Pensions Audit Sub Committee on EU Tax Claims and Other Income Tax Recoveries:</p> <p>WTax was appointed in 2018, on a no win no fee basis, to recover any withholding tax not normally recovered by the custodian. WTax has decided to make additional claims in Germany. Claims covering the calendar years 2015, 2016 and 2017, totalling £997k have been made.</p>
Israel	<p>Summary: Approximately £110,961 may be reclaimable through double tax treaty relief. In the first instance, we would recommend discussing this point with NT to determine if they are able to reclaim this amount through their standard procedures. The completion of some tax documentation may be necessary. Deloitte would be happy to assist if needed.</p>	<p>LPF comment: NT has been contacted on this point and we await their comments.</p> <p>NT response: In 2018 there was a change in the statute of limitations in Israel which allowed NT to retrospectively reclaim past withholding tax.</p> <p>LPF Conclusion: The matter seems to be resolved. However, we have asked for confirmation.</p>
South Korea	<p>Summary: 22% WHT has been incurred on all dividends. There may be an opportunity for double tax treaty reclaims c. £3,214.94. This should be queried with your custodian in the first instance.</p>	<p>LPF comment: NT has been contacted on this point and we await their comments.</p> <p>NT response: There was a lapse in relief at source documentation due to the name difference (City of Edinburgh). This has since been resolved and documentation is in place for the reduced rates.</p> <p>LPF Conclusion: The matter is resolved.</p>

Country	Findings	Conclusions as at Date of Preparation of Report to Pensions Audit Sub-Committee
Taiwan	<p>Summary: Approximately £296,152 is reclaimable through double tax treaty relief. Deloitte has already been engaged to provide support in this regard.</p>	<p>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 £469k. A top up claim was submitted in 2013 for £192k. These claims have now been paid. Therefore, it should be possible to make claims from 2013 onwards.</p> <p>LPF Conclusion: As discussed in the separate report to the Pensions Audit Sub Committee on EU Tax Claims and Other Income Tax Recoveries:</p> <p>After reviewing a number of quotations, Deloitte has been appointed to make claims for three calendar years (2016, 2017 and 2018). The potential amount to be recovered is in excess of £700k.</p>