

# Pensions Audit Sub Committee

2.00pm, Tuesday, 10 December 2019

## Investment Income Review Cross Border Withholding Tax

Item number	5.3
Executive/routine	
Wards	All
Council Commitments	

### 1. Recommendations

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The Pensions Audit Sub Committee is requested to:

- 1.1 note the report and highlight any points it would like to raise at the Pensions Committee on 11 December 2019.

**Stephen S. Moir**

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## Investment Income Review Cross Border Withholding Tax

### 2. Executive Summary

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- 2.1 This report provides information on a benchmarking assurance review, prepared by Deloitte, into the effectiveness of the procedures in place to manage the tax exposure on the investment income of the Lothian Pension Fund and the Scottish Homes Pension Fund.
- 2.2 The review 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.

### 3. Background

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- 3.1 Lothian Pension Fund (LPF) 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 2018/19 financial year the funds earned income from companies in 37 different countries.
- 3.2 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.
- 3.3 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.
- 3.4 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.

- 3.5 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.
- 3.6 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**

- 3.7 The custodian appointed for the two 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**

- 3.8 The tables below show the movement in the reclaimable tax balances during the 2018/19 and 2017/18 financial years for LPF and SHPF.

<b>Lothian Pension Fund</b>	<b>2018/19 £</b>	<b>2017/18 £</b>
Brought Forward 1 April	7,659,745.17	4,609,963.36
Recoverable tax accrued during year	4,525,904.62	4,258,212.07
Claims paid during year	(3,119,995.53)	(1,208,430.26)
Carried Forward 31 March	9,065,654.26	7,659,745.17

<b>Scottish Homes Pension Fund</b>	<b>2018/19 £</b>	<b>2017/18 £</b>
Brought Forward 1 April	44,822.84	-
Recoverable tax accrued during year	306.41	46,229.12
Claims paid during year	(14,252.54)	(1,406.28)
Carried Forward 31 March	30,876.71	44,822.84

- 3.9 The balance carried forward increased by £1,406k for LPF and decreased by £14k for SHPF.
- 3.10 The year-end recoverable tax balances at 31 March 2019 and 31 March 2018, broken-down by country, are provided for each of the Funds in the tables below.

<b>Lothian Pension Fund</b>	<b>Reclaim Amount 31/3/19 £</b>	<b>Number of Dividends 31/3/19</b>	<b>Reclaim Amount 31/3/18 £</b>	<b>Number of Dividends 31/3/18</b>
Austria	53,428.52	12	55,867.68	18
Denmark	95,714.69	30	70,191.73	21
France	3,556.67	5	154,186.04	16
Germany	2,920,338.37	74	1,821,509.69	47
Israel	16,408.26	4	-	-
Netherlands	165,944.30	14	291,839.23	24
Norway	430,879.15	28	343,270.30	22
Portugal	44,252.27	1	-	-
Spain	-	-	2,048.54	1
Switzerland	5,147,938.86	61	4,712,958.99	61
United Kingdom*	187,193.17	10	207,872.97	12
<b>Grand Total</b>	<b>9,065,654.26</b>	<b>239</b>	<b>7,659,745.17</b>	<b>222</b>

<b>Scottish Homes Pension Fund</b>	<b>Reclaim Amount 31/3/19 £</b>	<b>Number of Dividends 31/3/19</b>	<b>Reclaim Amount 31/3/18 £</b>	<b>Number of Dividends 31/3/18</b>
Canada	1,010.82	2	3,702.48	8
France	-	-	9,580.77	3
Germany	11,916.81	4	12,124.28	4
Japan	1,427.77	1	1,380.31	1
Netherlands	1,547.36	4	2,361.45	4
Norway	4,548.94	6	4,634.87	6
Switzerland	8,697.30	2	8,401.98	2
United Kingdom*	1,727.71	4	2,636.70	4
<b>Grand Total</b>	<b>30,876.71</b>	<b>23</b>	<b>44,822.84</b>	<b>32</b>

\* Relates to UK listed overseas companies dividends.

- 3.11 SHPF 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 2019 relating to this period of equity investment.
- 3.12 For LPF, Switzerland accounts for 56% (62% at 31 March 2018) for the total amount receivable, and for the Scottish Homes Pension Fund 28%. The reason 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.
- 3.13 The Swiss, German, Dutch and Norwegian claims are analysed in more detail later in this report.

## 4. Main report

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### **Benchmarking (Assurance) Review**

- 4.1 Given the complexity and scale of the taxation of investment income, it is important that LPF's 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.
- 4.2 In order to assess the effectiveness of NT's work, Deloitte has been commissioned to prepare a benchmarking assurance report. The remit was to carry out a review of the WHT suffered for the period 1 August 2018 to 31 July 2019. 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**

- 4.3 The Deloitte study found that in general optimal WHT rates appear to have been achieved by the Fund for the majority of dividend distributions received. 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.
- 4.4 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.
- 4.5 The Deloitte report highlights “the vast majority of pending claims are just waiting for the 2019 year to end in order for them to be processed in 2020”. However, examples have been identified of NT's claims processing being slower than the market standard for such work with the most material of these being for the Swiss and German markets. 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.
- 4.6 Swiss claims accounted for 56% (£5,148k) 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
	31/10/19 £	31/3/19 £	31/3/18 £	
2016	-	-	1,602k	Paid in 2018/19
2017	2,244k	2,208k	2,133k	NT status at 31 October 2019: "Agreed with Sub Custodian". Awaiting confirmation of when reclaim will be made.
2018	2,145k	2,110k	978k	NT status at 31 October 2019: "Reclaim Submitted to Sub Custodian". There is no requirement for action from LPF.
2019	2,214k	830k	-	Claim cannot be made until the end of the calendar year.
<b>Total</b>	<b>6,603k</b>	<b>5,148k</b>	<b>4,713k</b>	

4.7 The reason for the increase in the balance for the Swiss claims is the 2017 claim not being paid until the 2018/19 financial year. The factors accounting for the delay have been queried with NT.

4.8 NT has stated that the 2017 reclaims were submitted in 2018 and although repayment has been agreed funds have yet to be received.

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

Year	Lothian Pension Fund	Lothian Pension Fund	Lothian Pension Fund	Comment
	31/10/19 £	31/3/19 £	31/3/18 £	
2016	702k	702k	714k	NT status at 31 October 2019: Agreed with Sub Custodian". Awaiting confirmation of when reclaim will be made.
2017	955k	954k	971k	NT status at 31 October 2019: "Market Issue"
2018	1,126k	1,125k	137k	NT status at 31 October 2019: "Market Issue"
2019	1,418k	139k	-	NT status at 31 October 2019: "Market Issue"
<b>Total</b>	<b>4,201k</b>	<b>2,920k</b>	<b>1,822k</b>	

4.10 The German claims relating to the 2016 period have been accepted by the sub custodian, the Fund now awaits payment of these claims. For claims 2017 onwards the Germany Tax Authorities have introduced a holding period requirement where claimants must have not traded 45 days prior to and after the dividend ex-date where the reclaim is greater than 15%. UK pension funds are caught under this bracket. This is why all reclaims from 2017 onwards have been assigned a "Market Issue" status as NT review its operations to be able to capture this new requirement.

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

Year	Lothian Pension Fund	Lothian Pension Fund	Lothian Pension Fund	Comment
	31/10/19 £	31/3/19 £	31/3/18 £	
2016	-	101k	103k	Paid 2019/20
2017	-	216k	221k	Paid 2019/20
2018	-	114k	20k	Paid 2019/20
<b>Total</b>	-	<b>431k</b>	<b>344k</b>	

4.12 All Norwegian claims were settled in October 2019

4.13 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
	31/10/19 £	31/3/19 £	31/3/18 £	
2017	-	36k	255k	<b>Paid 2019/20</b>
2018	54k	92k	36k	Partial payment Paid 2019/20
2019	297k	38k	-	Too early to claim
Total	351k	166k	291k	

4.14 It is worth noting that Netherlands tax periods are calculated on a calendar year basis. This is the reason why a partial payment of withheld tax was received for the 2018/19 period.

### Taiwanese Claims

4.15 Previous years cross border withholding tax reviews had identified the opportunity to make additional claims to recover tax deducted on dividends from Taiwanese companies.

4.16 After reviewing a number of quotations, Deloitte has been appointed to make claims for three calendar years (2016, 2017 and 2018).

4.17 All reclaims submitted for these periods have been successful. As at 31<sup>st</sup> October 2019 £693k of withheld income has been returned to the Fund while approximately an additional £250k is expected by the end of the year.

## 5. Next Steps

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5.1 LPF will continue to monitor the withheld tax on the pension funds' investments and ensure it maximises the income it receives, expediting the recovery of tax when required.

## **6. Financial impact**

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- 6.1 The financial impact of the withholding tax claims is described in section 3.8 of this report.

## **7. Stakeholder/Community Impact**

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- 7.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the pension funds and they are invited to comment on the relevant matters at Committee meetings.
- 7.2 There are no adverse health and safety, governance, compliance or regulatory implications as a result of this report. The forward planning of the Committees' agendas should facilitate improved risk management and governance for the pension funds.
- 7.3 There are no adverse sustainability impacts arising from this report.

## **8. Background reading/external references**

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- 8.1 None.

## **9. Appendices**

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



10 December 2019

## 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
Israel	<p>Summary: Approximately £93k 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><b>LPF comment:</b> NT has been contacted on this point and we await their comments.</p> <p><b>NT response:</b> Dividends originated from revenues generated abroad would be subject to 25%.</p> <p><b>LPF Conclusion:</b> The matter seems to be resolved. However, we have asked for confirmation.</p>
United States	<p>Summary: Approximately £58k may be reclaimable through double tax treaty relief. This appears to relate to a single position where full UK pension fund relief has not been applied. 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><b>LPF comment:</b> NT has been contacted on this point and we await their comments.</p> <p><b>NT response:</b> The withholding related to a UK ADR which was subject to the 21% withholding tax rate.</p> <p><b>LPF Conclusion:</b> The matter seems to be resolved. However, we have asked for confirmation.</p>
Italy	<p>Summary: Approximately £112k may be reclaimable through EU law reclaims. Deloitte can provide support in this regard if needed. However, we would note this may be a very long process, as Italy are not currently processing claims. As such, the cost/benefit may not warrant such a claim.</p>	<p><b>LPF comment:</b> WTax was appointed in 2018, on a no win no fee basis, to recover any withholding tax not normally recovered by the custodian.</p> <p>The Italian reclaim process can be time consuming with the average time to process reclaims being 8 years. There is also no guarantee of success. To date WTax have shown no interest in participating in this market.</p> <p><b>LPF Conclusion:</b> The Fund is inclined not to pursue these reclaims.</p>