



Pensions Audit Sub Committee

2.00pm, Tuesday, 8 December 2020

Investment Income Review Cross Border Withholding Tax

1. Recommendations

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 9 December 2020

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Investment Income Review Cross Border Withholding Tax

2. Executive Summary

- 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

- 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 2019/20 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 2019/20 and 2018/19 financial years for LPF and SHPF.

Lothian Pension Fund	2019/20 £	2018/19 £
Brought Forward 1 April	9,065,654.26	7,659,745.17
Recoverable tax accrued during year	7,672,784.97	4,525,904.62
Claims paid during year	(1,838,489.56)	(3,119,995.53)
Carried Forward 31 March	14,899,949.67	9,065,654.26

Scottish Homes Pension Fund	2019/20 £	2018/19 £
Brought Forward 1 April	30,876.71	44,822.84
Recoverable tax accrued during year	786.93	306.41
Claims paid during year	(4,559.51)	(14,252.54)
Carried Forward 31 March	27,104.13	30,876.71

- 3.9 The balance carried forward increased by £5,834k for LPF and decreased by £3.8k for SHPF.
- 3.10 The year-end recoverable tax balances at 31 March 2020 and 31 March 2019, broken-down by country, are provided for each of the Funds in the tables below.

Lothian Pension Fund	Reclaim Amount 31/03/2020 £	Number of Dividends 31/03/2020	Reclaim Amount 31/03/2019 £	Number of Dividends 31/03/2019
Austria	25,067.49	4	53,428.52	12
Belgium	630,173.12	10	-	-
Canada	858.89	1	-	-
Denmark	216,821.65	39	95,714.69	30
Finland	25,837.30	1	-	-
France	3,652.46	4	3,556.67	5
Germany	4,479,229.77	100	2,920,338.37	74
Israel	17,691.23	4	16,408.26	4
Netherlands	503,818.43	29	165,944.30	14
Norway	-	-	430,879.15	28
Portugal	69,537.45	2	44,252.27	1
Spain	24,472.18	1	-	-
Switzerland	8,498,188.54	91	5,147,938.86	61
United Kingdom	404,601.16	15	187,193.17	10
Grand Total	14,899,949.67	301	9,065,654.26	239

Scottish Homes Pension Fund	Reclaim Amount 31/03/2020 £	Number of Dividends 31/03/2020	Reclaim Amount 31/03/2019 £	Number of Dividends 31/03/2019
Canada	-	-	1,010.82	2
Germany	12,237.72	4	11,916.81	4
Japan	1,538.37	1	1,427.77	1
Netherlands	-	-	1,547.36	4
Norway	3,920.32	6	4,548.94	6
Switzerland	9,407.72	2	8,697.30	2
United Kingdom*	-	-	1,727.71	4
Grand Total	27,104.13	13	30,876.71	23

* 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 2020 relating to this period of equity investment.
- 3.12 For LPF, Switzerland accounts for 57% (56% at 31 March 2019) for the total amount receivable, and for the Scottish Homes Pension Fund 35% (28% at 31 March 2019). 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, Belgian and Dutch claims are analysed in more detail later in this report.

4. Main Report

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 2019 to 31 July 2020. 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. Deloitte's did identify some potential opportunities and issues, however after discussion with NT on the specific cases the Fund is comfortable that no further action is required.
- 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 2020 year to end in order for them to be processed in 2021". 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 57% (£8,498k) 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
	30/9/20 £	31/3/20 £	31/3/19 £	
2017	-	2,388k	2,208k	Paid in 2020/21
2018	-	2,283k	2,110k	Paid in 2020/21
2019	2,380k	2,356k	830k	NT status at 30 September 2020: "Claim Under Preparation". There is no requirement for action from LPF.
2020	2,956k	1,471k	-	Claim cannot be made until the end of the calendar year.
Total	5,336k	8,498k	5,148k	

4.7 The reason for the increase in the balance for the Swiss claims is the 2017/18 claims not being paid until the 2019/20 financial year. Unfortunately, these delays seem to be a common theme in the market just now.

4.8 NT has provided warning that 2019's claims may be delayed. Due to the pandemic, resource in the sub custodian offices have been stretched with teams prioritising statute of limitations items meaning 2019 income tax reclaims that would normally be submitted in Q1/Q2 of 2020 are taking longer to get processed.

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
	30/9/20 £	31/3/20 £	31/3/19 £	
2016	739k	721k	702k	NT status at 30 September 2020: Reclaim Submitted to Sub Custodian".
2017	1,005k	980k	954k	NT status at 30 September 2020: "Market Issue"
2018	1,184k	1,155k	1,125k	NT status at 30 September 2020: "Market Issue"
2019	1,347k	1,456k	139k	NT status at 30 September 2020: "Market Issue"
2020	1,348k	167k	-	NT status at 30 September 2020: "Market Issue"
Total	5,623k	4,479k	2,920k	

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 Belgium, the position for the LPF claims can be summarised as follows:

Year	Lothian Pension Fund	Lothian Pension Fund	Lothian Pension Fund	Comment
	30/9/20 £	31/3/20 £	31/3/19 £	
2019	564k	550k	-	NT status at 30 September 2020: “Reclaim Submitted to Sub Custodian”
2020	283k	80k	-	Claim cannot be made until the end of the calendar year.
Total	847k	630k	-	

4.12 Like Germany the Belgian tax authorities have introduced a holding period requirement for foreign pension funds. NT are working on a procedure to automate this process.

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
	30/9/20 £	31/3/20 £	31/3/19 £	
2017	-	-	36k	Paid 2019/20
2018	56k	55k	92k	Partial payment Paid 2019/20
2019	389k	380k	38k	NT status at 30 September 2020: “Reclaim Submitted to Sub Custodian”
2020	378k	69k	-	Claim cannot be made until the end of the calendar year.
Total	823k	504k	166k	

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 2019/20 period.

5. Financial impact

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

6. Stakeholder/Regulatory Impact

- 6.1 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.
- 6.2 There are no adverse health and safety, governance, compliance or regulatory implications as a result of this report.

7. Background reading/external references

- 7.1 None.

8. Appendices

- 8.1 None.