



Pensions Audit Sub Committee

2.00pm, Tuesday, 6 December 2022

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 Committee on 7 December 2022.
- 1.2 note further that whilst the review by E&Y shows that Northern Trust is generally applying the correct withholding tax rates on investment income, we have reminded our global custodian of its obligation to take all appropriate steps to expedite receipt of withholding tax reclaims.

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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 Ernst & Young (E&Y), 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. E&Y were also asked to comment on the length of time taken to reclaim withheld tax. Although its comments were relatively neutral, the Fund has some concerns with the lack of progress in some markets which it is following up with Northern Trust directly. 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 2021/22 financial year the funds earned income from companies in 34 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 2021/22 and 2020/21 financial years for LPF and SHPF.

| Lothian Pension Fund | 2021/22 £ | 2020/21 £ |
|-------------------------------------|----------------------|----------------------|
| Brought Forward 1 April | 14,900,747.76 | 14,899,949.67 |
| Recoverable tax accrued during year | 7,042,029.31 | 5,684,175.59 |
| Claims paid during year | (779,407.62) | (5,683,377.50) |
| Carried Forward 31 March | 21,163,369.45 | 14,900,747.76 |

| Scottish Homes Pension Fund | 2021/22 £ | 2020/21 £ |
|-------------------------------------|----------------------|----------------------|
| Brought Forward 1 April | 11,780.50 | 27,104.13 |
| Recoverable tax accrued during year | (93.92) | (188.90) |
| Claims paid during year | - | (15,134.73) |
| Carried Forward 31 March | 11,686.58 | 11,780.50 |

- 3.9 The balance carried forward increased by £6.3m for LPF and remains around £11.7k for SHPF.
- 3.10 The year-end recoverable tax balances at 31 March 2022 and 31 March 2021, broken-down by country, are provided for each of the Funds in the tables below.

| Lothian Pension Fund | Reclaim Amount 31/03/2022 £ | Number of Dividends 31/03/2022 | | Reclaim Amount 31/03/2021 £ | Number of Dividends 31/03/2021 |
|-----------------------------|--|---|--|--|---|
| Austria | 13,346.69 | 2 | | 13,453.94 | 2 |
| Belgium | 1,136,624.71 | 23 | | 965,970.17 | 17 |
| Canada | 996,988.86 | 104 | | 212,156.72 | 21 |
| Denmark | 434,170.34 | 49 | | 320,376.08 | 46 |
| Finland | 1,879,923.50 | 11 | | 560,947.48 | 6 |
| France | 5,447.90 | 2 | | - | - |
| Germany | 6,519,623.14 | 151 | | 5,556,545.69 | 127 |
| Netherlands | 471,209.40 | 28 | | 612,486.73 | 31 |
| Portugal | | - | | 50,632.48 | 3 |
| Spain | 84,627.24 | 8 | | - | - |
| Switzerland | 8,749,159.87 | 89 | | 6,131,495.87 | 68 |
| United Kingdom* | 862,518.87 | 20 | | 476,662.60 | 18 |
| United States | 9,728.93 | 2 | | | |
| Grand Total | 21,163,369.45 | 489 | | 14,900,746.76 | 339 |

| Scottish Homes Pension Fund | Reclaim Amount 31/03/2022 £ | Number of Dividends 31/03/2022 | | Reclaim Amount 31/03/2021 £ | Number of Dividends 31/03/2021 |
|------------------------------------|--|---|--|--|---|
| Germany | 11,686.58 | 4 | | 11,782.50 | 4 |
| Grand Total | 11,686.58 | 4 | | 11,782.50 | 4 |

* 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 2022 relating to this period of equity investment.
- 3.12 For LPF, Switzerland accounts for 41% (41% at 31 March 2021) for the total amount receivable. 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 Finnish 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, E&Y 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 2021 to 31 July 2022. E&Y 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 E&Y study found that in general optimal WHT rates appear to have been achieved by the Fund for the majority of dividend distributions received. Although E&Y were not overly concerned, discussions continue with NT over the length of time taken to receive reclaims (particularly for the German and Swiss markets) where the Fund hopes claims can be expedited.
- 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 Swiss claims accounted for 41% (£8,749k) 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 |
|------|----------------------|----------------------|----------------------|--|
| | 30/9/22 £ | 31/3/22 £ | 31/3/21 £ | |
| 2019 | 2,573k | 2,333k | 2,177k | NT status at 30 September 2022: "Reclaim Submitted to Sub Custodian" |
| 2020 | 3,239k | 2,937k | 2,740k | NT status at 30 September 2022: "Certification Requested" |
| 2021 | 2,398k | 2,175k | 1,214k | NT status at 30 September 2022: "Claim under preparation" |
| 2022 | 2,660k | 1,304k | - | Claim cannot be made until the end of the calendar year. |

| Year | Lothian Pension Fund | Lothian Pension Fund | Lothian Pension Fund | Comment |
|--------------|----------------------|----------------------|----------------------|---------|
| Total | 10,870k | 8,749k | 6,131k | |

4.6 NT had previously warned that delays in the receipt of reclaims should be expected due to the pandemic. Tax reclaims for this market are predominantly paper based, and only with staff returning to their office could claims be submitted. They have reassured that there is no risk in the statute of limitations being missed for making the necessary submissions and the processing of the backlog has been prioritised.

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

| Year | Lothian Pension Fund | Lothian Pension Fund | Lothian Pension Fund | Comment |
|--------------|----------------------|----------------------|----------------------|--|
| | 30/9/22 £ | 31/3/22 £ | 31/3/21 £ | |
| 2016 | 715k | 688k | 694k | NT status at 30 September 2022: "Reclaim Submitted to Sub Custodian" |
| 2017 | 972k | 936k | 943k | NT status at 30 September 2022: "Reclaim Submitted to Sub Custodian" |
| 2018 | 1,146k | 1,103k | 1,112k | NT status at 30 September 2022: "Reclaim Submitted to Tax Authority" |
| 2019 | 1,444k | 1,390k | 1,401k | NT status at 30 September 2022: "Reclaim Submitted to Sub Custodian" |
| 2020 | 1,304k | 1,256k | 1,266k | NT status at 30 September 2022: "Reclaim Submitted to Sub Custodian" |
| 2021 | 1,013k | 976k | 141k | NT status at 30 September 2022: "Market Issue" |
| 2022 | 1,661k | 169k | - | Claim cannot be made until the end of the calendar year. |
| Total | 8,255k | 6,520k | 5,557k | |

4.8 The Germany Tax Authorities introduced a holding period requirement where claimants must not of traded 45 days prior to and after the dividend ex-date where the reclaim is greater than 15%. UK pension funds have also been caught under this bracket. NT now have a procedure in place to capture this requirement and has submitted reclaims for 2016-2020 which the Fund now awaits payment.

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

| Year | Lothian Pension Fund | Lothian Pension Fund | Lothian Pension Fund | Comment |
|--------------|----------------------|----------------------|----------------------|--|
| | 30/9/22 £ | 31/3/22 £ | 31/3/21 £ | |
| 2019 | 546k | 526k | 530k | NT status at 30 September 2022: "Reclaim Submitted to Sub Custodian" |
| 2020 | 449k | 432k | 436k | NT status at 30 September 2022: "Market Issue" |
| 2021 | 185k | 179k | - | NT status at 30 September 2022: "Market Issue" |
| 2022 | 117k | - | - | Claim cannot be made until the end of the calendar year. |
| Total | 1,297k | 1,137k | 966k | |

4.10 Like Germany the Belgian tax authorities have introduced a holding period requirement for foreign pension funds. NT have now implemented a procedure to automate the process for collecting this data.

4.11 Further comment is being sought from NT on 2020/21 tax reclaims currently marked as "Market Issue", thought reclaims are currently in NT's backlog of paperwork awaiting submission.

4.12 For Finland, the position for the LPF claims can be summarised as follows:

| Year | Lothian Pension Fund | Lothian Pension Fund | Lothian Pension Fund | Comment |
|--------------|----------------------|----------------------|----------------------|--|
| | 30/9/22 £ | 31/3/22 £ | 31/3/21£ | |
| 2020 | 477k | 459k | 463k | NT status at 30 September 2022: "Reclaim Submitted to Sub Custodian" |
| 2021 | 1,284k | 1,236k | 98k | NT status at 30 September 2022: "Claim under preparation" |
| 2022 | 1,478k | 184k | | Claim completed at the end of the calendar year. |
| Total | 3,239k | 561k | 561k | |

4.13 Previously Finnish market offered tax relief at source, instead now full 35% tax rate suffered on investment income which can then be reclaimed. NT have commented that it is a complex manual process with additional steps required for claimants reclaiming below a 15% tax rate (LPF entitled to 0%).

4.14 NT have submitted all required paperwork for the 2020 period and is in the process of submitting a reclaim for the 2021 period.

- 4.15 The Canadian position (£997k) is also of note. All withheld tax relates to the 2021 period where new requirements were put in place. NT now have a automated process eliminating the need for retrospective reclaims. 2021 reclaims are currently in the process of being submitted.
- 4.16 E&Y have highlighted the opportunity to reclaim withheld tax in the Taiwanese market. Due to the complexity of the reclaim process this falls out of the scope of the claims the custodian would do on behalf of their clients. The Fund has participated in these reclaims in the past and plans to do a procurement exercise to appoint a consultant to do this work.

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

None.