



# Board of Retirement Regular Meeting

## Sacramento County Employees' Retirement System

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### Agenda Item 24

**MEETING DATE:** August 19, 2020

**SUBJECT:** Withholding Tax Recovery Services

**SUBMITTED FOR:** \_\_\_ Consent       X  Deliberation and Action      \_\_\_ Receive and File

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### **RECOMMENDATION**

Staff recommends the Board approve the use of WTax to perform withholding tax recovery services on behalf of SCERS, and authorize SCERS' Chief Executive Officer to execute any documents related to the recommendation.

### **PURPOSE**

This agenda item contributes to the effective management and oversight of investment activities.

### **BACKGROUND**

As an investor in foreign securities, SCERS is subject to withholding tax charged by foreign governments on income paid to SCERS on these investments. Income examples include dividend payments on international equity securities. In comparison to U.S. law, which does not automatically withhold tax on income distributions for U.S. investors, some foreign countries automatically impose a withholding tax ranging from 15% to 35%, a portion of which may be recoverable. SCERS' custodian bank, State Street, has the primary authority for recovering withholding tax on behalf of SCERS; however, the tax reclaim process can be complex with legal requirements that vary by country and tax jurisdiction. The tax reclaim process is an ancillary business for State Street, which has created the opportunity for other service providers, such as WTax, to engage with investors such as SCERS to provide a supplementary service for recovering any excess tax withheld that was unable to be recovered by State Street.













WTax, a subsidiary of VAT IT Group, is headquartered in London and has offices across North America, Europe, and Asia. WTax offers a fully outsourced, end-to-end service to its clients. The process involves collecting data from custodian banks necessary to file claims, reconciling and evaluating the data for possible claims, filing necessary documentation for tax recovery, tracking claims throughout the process, and submitting funds back to clients after the recovery process is complete. The services are performed on a contingency-only fee basis, with fees based only on the amount they are able to recover on behalf of clients.

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## **DISCUSSION**

The history of withholding taxes on foreign income goes back several decades, as institutional investors expanded their investment portfolios from being predominately domestically oriented to include a larger portion of international investments. With increased investment in international securities, portfolios are exposed to a wide range of tax regulations imposed by foreign countries. Following World War II, the U.S. established tax treaties with most industrialized Western European countries and Japan to help encourage the inflow of capital for postwar recovery. Over time, the network of tax treaties between the U.S. and foreign countries expanded, designed to encourage international investment and spur global economic growth. The tax treaties help reduce or eliminate double taxation on cross-border income (i.e. dividend and interest on securities held by foreign investors) and also enhance cooperation among tax authorities, helping to reduce international tax avoidance. While the tax treaties provide a clear benefit to investors in foreign securities, they also create challenges for investors who may lack the expertise necessary to interpret and administer the tax treaties and effectively capture the benefit of reduced taxes. The tax treaties, including applicable filing requirements, vary country by country and require specific knowledge of local tax laws and procedures, in order to minimize tax liability and potentially recapture all taxes withheld.

As an investor in international securities, SCERS has significant exposure to withholding taxes levied by foreign governments on the income paid by these investments. SCERS has a 20% target allocation to international equity, with approximately 70% of assets held in custody with SCERS' custodian, State Street Bank. The balance of SCERS' international equity portfolio is invested in commingled funds where SCERS does not have custody of the investments, and therefore, where SCERS does not control recovery of taxes withheld. Income paid on international equity securities, primarily dividends, is subject to withholding taxes levied by the country where the underlying company is domiciled. Unlike the U.S., where taxes are paid after the income is received, foreign countries will automatically withhold taxes irrespective of the ultimate tax liability of the investor. The withholding tax rates can vary significantly, but typically range from 15% to 35%. Therefore, the investor must file to reclaim the taxes that are withheld, based on the ultimate tax liability of the investor. The exhibit below shows the various tax withheld and potential recovery amounts by country. As noted in the exhibit, there is a significant difference between the gross dividend received and the net final dividend received, depending on the ability to recover the taxes withheld. The exhibit also shows the statute of limitations for filing claims on past taxes withheld, which can range from two to seven years.

Country	Gross Dividend	Tax Withheld	Dividend Received	Recoverable Taxes	Final Dividend Received	Statutes of Limitations
Australia 	100	30	70	15 or 30	85 or 100	7 years
Belgium 	100	30	70	15 or 30	85 or 100	5 years
Canada 	100	25	75	10 or 25	85 or 100	2 years
Finland 	100	30	70	15 or 30	85 or 100	5 years
France 	100	30	70	15	85	2 years
Germany 	100	26.375	73.625	11.375 or 26.375	85 or 100	4 years
Ireland 	100	20	80	20	100	4 years
Japan 	100	15.315	84.685	5.315 or 15.315	90 or 100	5 years
South Korea 	100	22	78	5.5	83.5	5 years
Spain 	100	19	81	4	85	4 years
Sweden 	100	30	70	15 or 30	85 or 100	5 years
Switzerland 	100	35	65	20 or 35	85 or 100	3 years

### Withholding Tax Recovery Process

For the assets held at SCERS' custodian (versus commingled funds), when an investment manager plans to invest in a foreign market, State Street will help facilitate the documentation necessary to access the market for investment. This documentation will often include registering SCERS as a foreign investor and opening any local custodian accounts. When available, State Street will look to submit for "relief at source," which allows for withholding taxes to be avoided, in whole or in part, at the outset as opposed to being claimed retroactively. While this is the most advantageous method, unfortunately, very few countries allow for "relief at source" in their tax provisions, and therefore SCERS must attempt to subsequently recover taxes after they are withheld.

State Street has the primary authority for attempting to recover taxes withheld on behalf of SCERS. The recovery process can be lengthy and can require significant documentation to file claims across the many countries that withhold taxes. As shown in the table above, the amount of tax withheld varies by country, but can be significant, generally ranging from 15% to 35%. While not all of the tax is fully recoverable, there are multiple methods for reclaiming the taxes, which will be discussed in this report.

After the custodian bank files for the tax reclaim with the foreign tax authority, depending on the jurisdiction, it could take anywhere from six months to several years to eventually receive the proceeds. The filing process requires the custodian bank to not only file the initial claims, but also to monitor existing claims and resolve any legal or administrative issues that may arise during the process, which may result in the investor not receiving the withheld tax they are entitled to.

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The methods for recovering taxes withheld fall under three general categories, which are:

- Double Tax Treaty (DTT) Claims
- Domestic Tax Legislation Claims
- European Court of Justice (ECJ) Claims

Double Tax Treaty Claims is the primary method that State Street uses to recover taxes on behalf of their clients. This methodology is based on the difference between the statutory withholding rate and the negotiated rate based on the applicable tax treaty signed between the U.S. and foreign country. This methodology is based on established tax treaties and is generally successful in reducing the tax withheld down to the negotiated treaty rate. For example, if the withholding rate is 30% and the tax treaty rate is 15%, State Street would generally be successful in recovering the 15% difference. However, as a tax-exempt investor, SCERS would still have the potential to recover an additional 15% that was not recovered under the DTT claim. This additional recovery opportunity is based on SCERS' being a tax-exempt entity, and therefore should not be subject to tax liability in most foreign countries. For example, in Switzerland and Belgium, U.S. pension plans are recognized as tax-exempt entities and SCERS should be able to recover the full amount of tax withheld. This would require additional action to file claims on behalf of the investor, in addition to the DTT claim. However, State Street is not able to fully recover these taxes, as filing these additional claims could be considered tax advice and would require State Street to make representations on behalf of clients, which they are not authorized to do.

Domestic Tax Legislation Claims present another opportunity for additional tax recovery, especially in countries where U.S. pension plans aren't officially recognized as tax-exempt. These claims are based on a foreign investment jurisdiction's domestic tax legislation, which can be utilized to receive a full or partial recovery of the tax withheld. The conditions of these exemptions differ significantly across various jurisdictions, requiring additional information and documentation necessary to file the claims and demonstrate compliance with the domestic legislation. SCERS' status as a tax exempt entity increases the availability of claims under this category, but the extent of refund opportunity varies by jurisdiction and investment type.

European Court of Justice Claims is a more recent development, resulting from European Union treaties and recent legal case outcomes. The legal precedent for these claims is based on different tax treatment for resident and non-resident investors. In 2014, the European Court of Justice decided that tax treatment of outbound dividends to a U.S. investment fund was contradictory to EU law and discriminatory withholding tax levies must be refunded<sup>1</sup>. This legal ruling presents the opportunity for U.S. based investors to file claims and potentially recover back taxes withheld, based on now established case law. This process also requires specific documentation necessary to support the claims. As this process is relatively new, the recovery timeline and expectations should be relatively conservative.

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<sup>1</sup> Deloitte AG, Financial Services, Tax & Legal, 2018

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### WTax Process and Proposal

WTax is a withholding tax recovery specialist, with offices in over 40 countries globally. WTax provides a fully outsourced recovery process with thousands of clients across the globe. Their client base ranges from U.S. based pension plans to large multi-national investment firms, including several of SCERS' investment managers. WTax is a subsidiary of the VAT IT Group, which was founded in 1999 and has over 1,500 employees and 15,000 clients, including over 50% of the Fortune 500 companies. The relationship with VAT IT Group provides extensive resources and support, including legal and accounting tax knowledge, to help facilitate the WTax recovery business. WTax works with over 100 global custodians, including SCERS' custodian State Street.

WTax offers a fully outsourced, end-to-end solution, which includes the collection of all supporting documentation, submission of all claim filings, monitoring and following up on outstanding claims, and remittance of recovery proceeds to clients. The process is designed to minimize the impact, and resources required, on investment and accounting staff of clients, as SCERS does not have the ability or expertise necessary to file claims on its own.

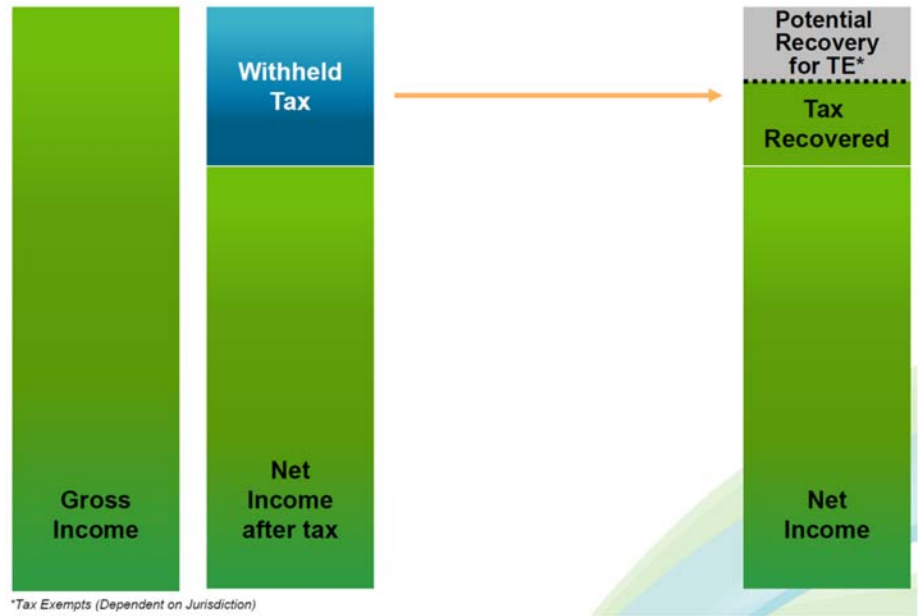
The service offered by WTax can be performed as a full service, serving as a client's exclusive agent covering all claim filing opportunities, or as a partial supplementary service to the withholding service recovery efforts performed by the custodian. The rate charged for the different service offerings (full service or supplementary), varies based on the complexity and expected recovery of the claims filed. As a supplementary service, the claim filing process is more complex, including ECJ and tax legislation claims, which require more supporting documentation and have a lower success rate, compared to the relatively easier DTT claims process performed by the custodians. Therefore, WTax charges a higher rate for the supplementary service compared to a full service offering.

A key component of the supplementary service is that it is performed on a fully contingent basis, where WTax is only compensated on the successful recovery of taxes withheld. Given the contingent fee model, and the complexity of the claim filing process, WTax charges 20% of all recovery proceeds received. The percentage charged is in line with WTax peers in the tax recovery business, and any net proceeds received by SCERS will be 100% additive to the plan. The only potential costs for SCERS are minimal fees for documentation requests, charged by State Street, and SCERS has the ability to review and approve these amounts before being charged. WTax fully evaluates the potential recovery for each claim, which must meet a minimum threshold amount, prior to requesting supporting documentation from State Street and incurring a charge.

At the initial on-boarding, WTax would request initial information from a client, including dividend and income history for the past several years. The initial claims process would attempt to recover past taxes withheld, prior to the expiration of statute of limitation, which varies by country and tax jurisdiction. The statute of limitations generally ranges from one to five years. After the initial recovery of past claims, WTax would then handle future recovery claims on an annual basis.

Recovery Tax Example

As discussed, the additional recovery potential is based on the amount of tax withheld, above what is currently being recovered by SCERS’ custodian State Street. The image depicts the potential recovery opportunity. The actual recovery for SCERS will vary based on the securities and countries invested in by SCERS’ managers, and the various tax regulations applicable to those investments. In addition, based on the statute of limitations across countries, there is the potential to initially file for back taxes withheld.



The following example roughly estimates the potential recovery for SCERS, going back two years.

SCERS International Equity Portfolio Market Value (in custody with State Street)	\$1.25 billion
Estimated Dividend Tax Rate	2%
Gross Dividend Income for Prior Two Years	\$50 million
Estimated Withholding Tax Rate	30%
Estimated Taxes Withheld	\$15 million
Estimated Taxes Recovered by State Street at 75%	\$11.25 million
Potential Additional Tax Reclaim Available	\$3.75 million
Estimated Gross Additional Recovery to SCERS**	\$1 million
Estimated Net Recovery to SCERS (after 20% WTax Fee)	\$800,000

*\*\* Conservatively assumes additional recovery of approximately 25% of potential tax reclaims available, based on complex nature of claim filings, statutory limitations, etc.*

In the example above, Staff identified \$800,000 in additional recovery opportunity, a conservative estimate given the relative success of State Street’s recovery efforts. However, as this would be an additional service that SCERS has not previously employed, any additional recovery amount would be completely additive to SCERS. On an ongoing basis, Staff estimates that withholding tax recovery services could reclaim approximately \$300,000 to \$400,000 annually for SCERS.

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### SCERS Due Diligence Process

SCERS began research on the withholding tax recovery process in late 2019. SCERS' staff had conversations with WTax in December 2019 and then subsequently met with WTax representatives in SCERS' office in February 2020. Unfortunately, the impact from the Coronavirus pandemic slowed the process, but since then SCERS has been able to hold multiple due diligence calls to specifically evaluate WTax and the overall withholding tax process. The due diligence process for SCERS included:

- Multiple follow up calls with WTax
- Reference check calls with WTax clients, including another California based public pension plan
- Peer analysis, including calls with WTax's major competitor
- Calls with State Street Bank, to understand their withholding tax recovery process
- Videoconference with one of SCERS' international equity managers, who utilizes WTax for their withholding tax recovery.

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# Withholding Tax Reclaim Presentation

August 19, 2020

SACRAMENTO COUNTY EMPLOYEES' RETIREMENT SYSTEM















# Introduction

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- Overview of Withholding Tax on Foreign Income
- Withholding Tax Reclaim Process
- Custodian's Role vs. Specialist Provider
- WTax Process and Proposal
- Benefit to SCERS

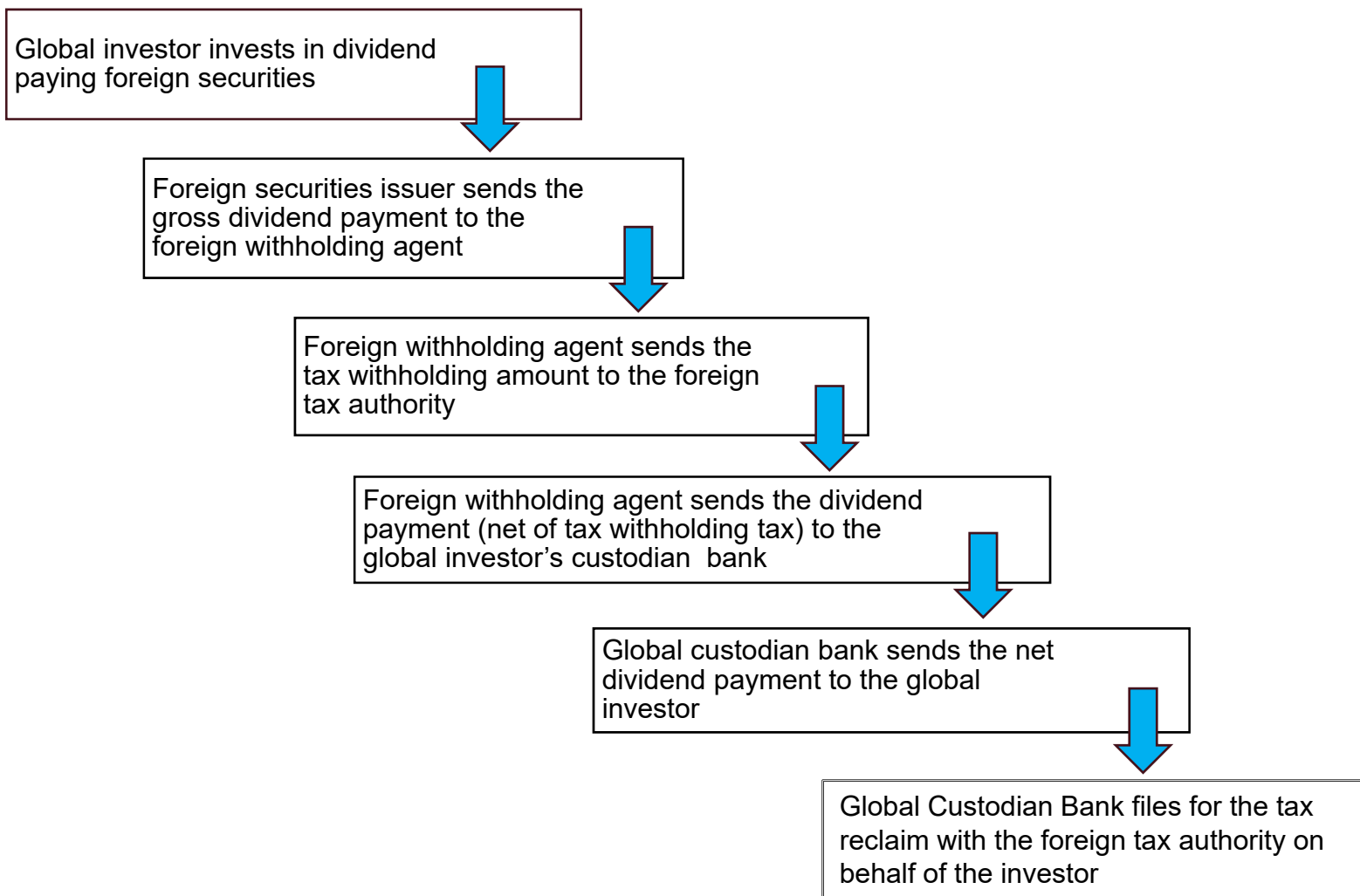
# Withholding Tax on Foreign Income

- Tax Automatically Withheld on Dividends and Interest Paid on Foreign Income
- Withholding Tax Rates Vary by Country
  - Typically Range from 15% to 35%

Country	Gross Dividend	Tax Withheld	Dividend Received	Recoverable Taxes	Final Dividend Received	Statutes of Limitations
Australia 	100	30	70	15 or 30	85 or 100	7 years
Belgium 	100	30	70	15 or 30	85 or 100	5 years
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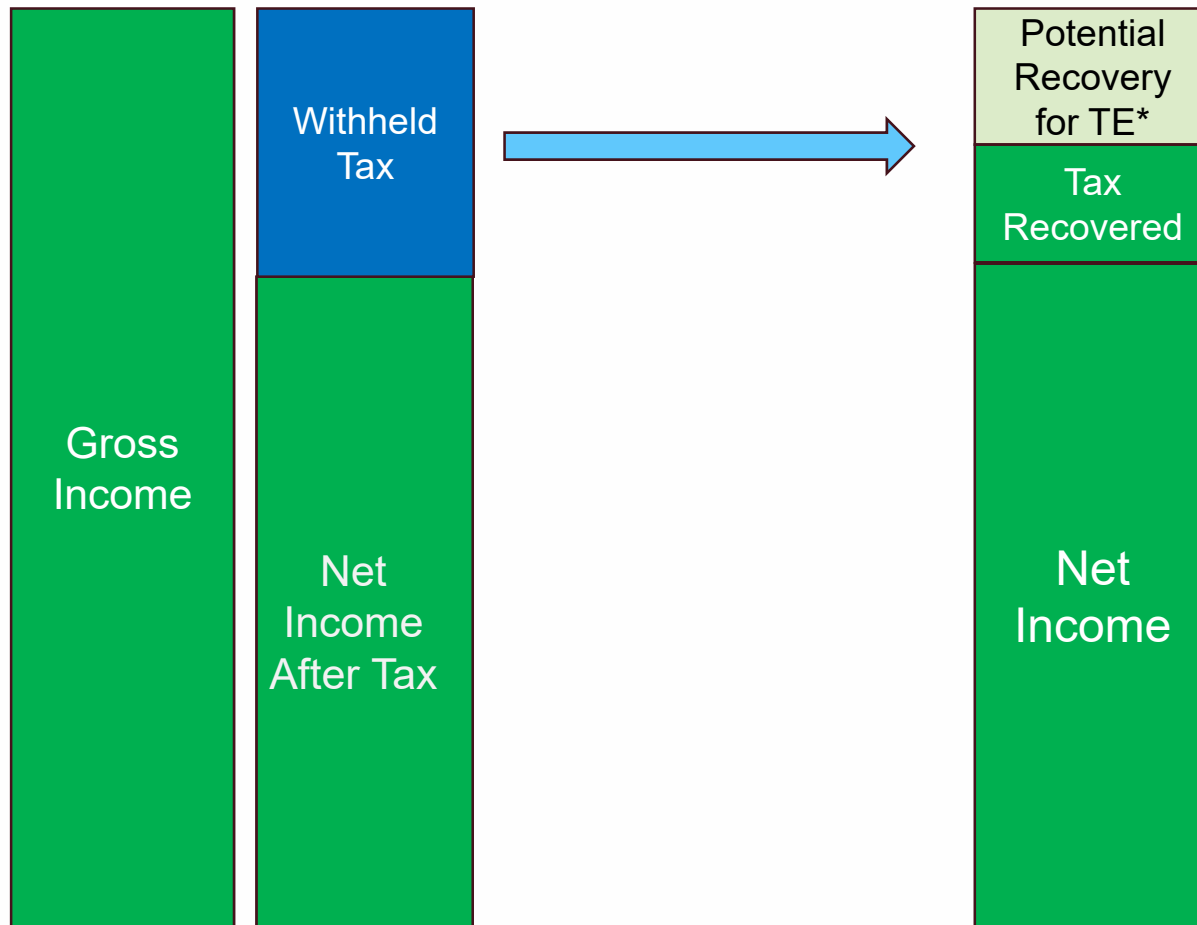
# Tax Withholding and Reclaim Process

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# Tax Withholding Recovery Opportunity

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\*Tax Exempt Entity – Dependent on Jurisdiction

# Custodian Role

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- SCERS' Custodian Bank has Primary Role in Foreign Investments and Tax Recovery Process
  - Assists SCERS in Opening Access to Foreign Markets
  - Filing for Relief at Source when available
  - Filing for Recovery under Double Tax Treaty Claims
- Per discussion with specialist providers and other pension plans, SCERS' Custodian Bank does a good job at withholding tax recovery
- However, they are limited in their ability to file certain claims, and aren't contractually bound to recover taxes on behalf of SCERS

# Specialist Provider Role

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- Specialist Provider has Supplementary Role to File Claims for Taxes Not Fully Recovered by Custodian
- Ability to File Claims under Alternate Methods Not Available to Custodian
  - File claims on behalf of SCERS as a tax-exempt investor
  - Tax Legislation and European Court of Justice Claims
- Complex Process Dependent on Tax Jurisdiction and Existing Tax Case Law
  - Requires specific legal and tax law knowledge across multiple countries

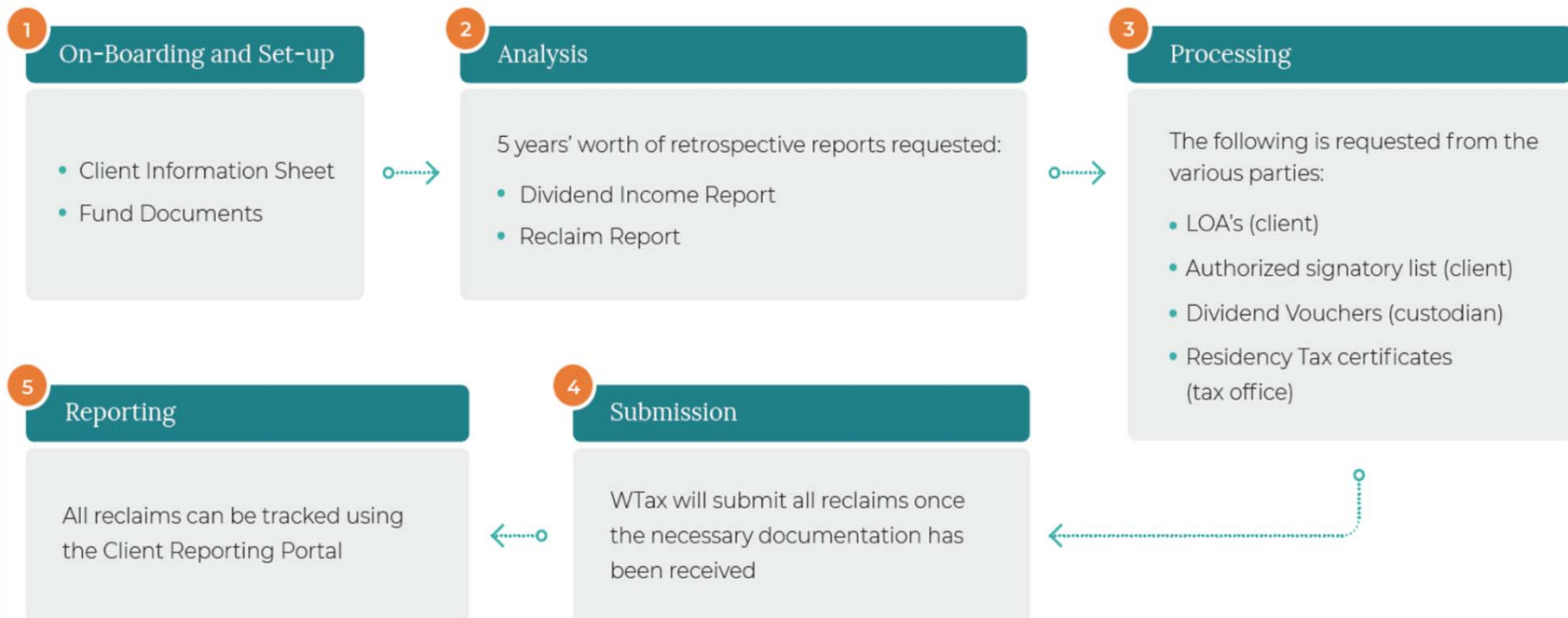
# WTax - Withholding Tax Recovery Specialist

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- Full Service Provider that covers all aspects of recovery process
- Headquartered in London, with 40 offices across the globe
- Subsidiary of VAT IT Group, providing additional tax law research and support
- Fully outsourced, end-to-end solution
- Services performed on a contingent basis, with fees based on a percentage of taxes recovered

# WTax Implementation and Tax Recovery Process

## Service Implementation Summary



- Initial claim filing covering back taxes withheld, up to applicable statute of limitations by country



# WTax Service Proposal

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- Supplementary service that works to capture withholding taxes not recovered by Custodian
- Initial claim filing covering back taxes withheld
- Annual process going forward
- Works with Custodian Bank to identify taxes withheld and gather supporting documentation needed
  - WTax works with over 100 global custodians
- Fully contingent fee schedule
  - 20% of Taxes Recovered
  - Some minor ancillary fees for documentation and bank transfer fees

# Recovery Example

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- SCERS' International Equity Portfolio Value: \$1.25 billion
- Estimated Annual Dividends (2% Div Rate): \$25 million
- Estimated Taxes Withheld (30%): \$7.5 million
- Estimated Taxes Recovered by State Street (75%): \$5.625 million
- Potential Additional Tax Reclaim Available: \$1.875 million
- Estimated Gross Additional Recovery to SCERS: \$475,000
- Estimated Net Recovery to SCERS (after 20% fee): \$380,000
  
- **Initial Recovery for Prior Years Expected to Range from \$750k to \$1 million**
- **Any additional recovery amounts fully additive to plan assets**

# Questions?

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