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Foreign Withholding Taxes–How Much Money are You Leaving on the Table?

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Hedge funds, like many other investment vehicles, invest a portion of their assets cross border. In this context, cross-border means that the country where the income is generated (i.e., invested) is different from the country of residence of the underlying partners/investors in the fund. Hedge funds, by and large, are viewed by the various tax authorities as an entity that passes through all profits, dividends, etc. This separation of the fund, as an entity, from its members is called the "transparency" principle (look-through principle) and creates a problem which has led many hedge funds to lose out entirely on recovering excess withholding tax, to which they are entitled.

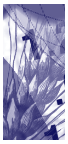
> *Each tax authority sets a Statute of Limitation on tax reclaims; therefore, often a hedge fund (or their tax reclaim agent) is able to go back, often over several years, and recover excess withholding tax on previous years' income – a windfall benefit.*

The reason a portion of the withholding tax may be reclaimable is that governments largely understand that the investor is being taxed on the income payment in the country where the investment is made and then being taxed again in their home country. As a result, pairs of countries (there are thousands of combinations) have entered into treaties with one another to alleviate some of this tax burden and to entice foreign investment into their markets. Investors can generally reclaim the difference between the statutory withholding rate and the treaty rate.

The problem for hedge funds is income on cross-border investments is taxed in the country where the income is generated, based on the level of knowledge the tax authority has about the ultimate beneficial owners of the income. Foreign tax authorities generally have no knowledge of the underlying partners so they tax the whole of the income at their (high) statutory withholding rate, even though the members of the fund may actually be entitled to a lower rate of taxation because of their residency and status. A typical international portfolio will add an average of 20 to 30 basis points in performance by reclaiming their entitlements (*source*: Globe Tax Services Inc.).

In addition to the recoverable tax from the foreign government, the entitlement can sometimes be enhanced by additional tax credits. As hedge funds often take large concentrated positions in securities, the absolute value of this recoverable can be quite substantial.

Due to recent changes in the dividend tax rate, it is often more beneficial to file the reclaim than to employ other strategies like using SWAPs or other synthetic vehicles to mitigate this issue. However, the primary reason most hedge funds ignore the issue is neither the hedge funds nor their



Foreign Withholding Taxes– How Much Money?

Country	Dividend	Taxes Withheld (%)	Dividend Received %	Recoverable Taxes (%)	Statute	Dividend Received (%)
Australia	100	30	70	15 or 30	No deadline	85-100
Austria	100	25	75	12.5 or 10	5 yrs	85 or 87.5
Canada	100	25	75	10 or 25	2 yrs	85-100
Finland	100	28 or 29	72 or 71	13 or 14	5 yrs	85
France	100	25	75	22 to 52.5	2 yrs	97-127.5
Germany	100	26.375 or 21.1	73.625 or 78.9	16.375 or 6.10	4 yrs	85-90
Italy	100	27	73	12	4 yrs	85
Netherlands	100	25	75	10 or 25	3 yrs	85-100
New Zealand	100	30	70	15 or 30	8 yrs	85-100
Sweden	100	30	70	15	5 yrs	85
Switzerland	100	35	65	20 or 35	3 yrs	85-100

*The table above shows the scale of the issue for the major developed markets regarding how much a U.S. hedge fund would normally receive and what it should actually receive if it files reclaims to recover its tax.

administrators maintain the experience, the extensive expertise or research to effectively file reclaims on behalf of their partners.

The final hurdle is maintaining the confidentiality of the partners in the fund. This can be achieved by using a reputable and knowledgeable agent to act as the go- between from the fund to the prime broker and the tax authorities. Typically, the prime broker has no knowledge of the underlying partners of its hedge fund clients and so does not have the information needed to calculate and file the reclaims. The prime brokers are, however, critical to the process as they are the custodians of the assets and maintain the official income payment records necessary to prove both payment and withholding. As the hedge fund industry matures and becomes subject to further regulation (as is happening with mandatory registration by the SEC), this issue will be increasingly viewed as one of fiduciary responsibility and best practice.

There's one final piece of good news! Each tax authority sets a Statute of Limitation on tax reclaims. So, in many cases, a hedge fund (or their tax reclaim agent) is able to go back, often over several years, and recover excess withholding tax on previous years' income – a windfall benefit.

GlobeTax is the pre-eminent provider of withholding tax services in the world. GlobeTax works on contingency and maintains strategic alliances with all major prime brokerage firms going back many years. Len A. Lipton is vice president of marketing for GlobeTax. For more information or analysis of the potential benefit of filing foreign tax reclaims for your fund, please contact Mr. Lipton at 212.747.9100 or ***len_lipton@globetax.com****, or Ross McGill, director of marketing for GlobeTax at 44 (0)20 7618 6692 or* ***ross_mcgill@globetax.com****.*

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