

Outsourcing Withholding Tax: Choosing the Right Partner

Ross McGill - Globe Tax Services - 6 September 2004

What's the Big Idea?

Anyone in the investment management chain who manages or receives cross border income directly or indirectly faces the issue of withholding tax. Many clients are over-taxed often by up to 35 per cent and they (or their custodians) have limited time in which to recover their entitlements. Some estimates of the amount of tax entitlements that go unrecovered each year are up to \$200bn. The recovery process is long, complex, error prone, requires extensive and constant research and close relationships with tax authorities to deliver value back to clients: a classic case for outsourcing to reduce costs and improve value.

Partner or Supplier

For investment management firms and custodians, outsourcing can be a difficult concept. There are sensitive issues that must be addressed including security and confidentiality. Addressing these issues is what defines the difference between a supplier and a partner. A supplier acts to the terms of a contract. A partner on the other hand is more motivated than a supplier and has a longer-term relationship in mind. This allows him to remove the specialist function from the client, but still stay in contact with the business and its needs and contribute to the client's business beyond that which would be expected of a supplier. The difference can be subtle because today everyone *calls* themselves a partner - it's the in-phrase. Being one is different.

Two issues separate suppliers from partners. One is the degree to which the firm is prepared to put its reputation and skills where its mouth is. The second is the recognition of the value and quality of the service provided. In withholding tax outsourcing, quality control and investment in IT must be so high that firms can provide services on a completely contingent basis. In other words, if they don't get the client's tax back, they don't get paid. What better demonstration of belief is there? Value is demonstrated in pricing structures. Some analysts think of tax recovery as data processing - that it doesn't matter whether the tax reclaim is for £100 or £100m: it's the same process. Wrong. Tax authorities are far more inquisitive about high value reclaims than small ones so they do take much more effort to recover.

Fixed price solutions may seem attractive but they reflect neither the real process nor the value and trust that outsourcing partners should demonstrate. They evidence a supplier mentality, not a partner mentality.

In summary, think only of what functions can reduce costs or create market advantage and think about what really differentiates your supposed outsourcing partner from actually being a supplier, and what that means for your business success.

Why Outsource? The six Cs

There are usually only three reasons given for outsourcing. In financial services and particularly withholding tax outsourcing we believe there are six.

Competency

Best practice requires relief at source, where available, to be obtained for the benefit of the client so he has maximum funds from day one. Some countries have accelerated recovery processes and failing to meet the deadline can result in a ten-year wait for client money. Some security types, such as ADRs have no direct reclaim possibility, only indirectly on the underlying shares and through the sponsoring bank. Some investment vehicles are transparent to tax authorities and reclaims may be missed if confidentiality keeps broker income streams and client identities separate. Some methodologies are transparent to tax authorities, so brokers who claim title to securities may think they are entitled to apply treaty rates, when foreign tax authorities will disagree and penetrate title to beneficial ownership. All this demonstrates the need for extreme competency and deep knowledge. Outsourcing becomes logical because it's the primary focus of the partner and all its expenditure is aimed at this one objective.

Complexity

There are around 200 countries in the world, each may or may not have a treaty with other countries for the avoidance of double taxation. For each of these country pairs there are a number of types of investor and a number of types of income, any combination of which can result in a different rate of withheld tax and treaty entitlement. The date on which the income is distributed also affects the entitlement and other factors increase the complexity further. The number of permutations is over 40 million. The in-house cost of recovery, for any fund with multi-residence members or custodians with broad client bases, will be prohibitive compared to the number of likely reclaims that will be generated. A good outsourcing firm succeeds because

its business model leverages economies of scale across the whole process. In the past 12 months the largest outsourcing firm in this area processed over one million tax reclaims. At that level, the focus of research and investment buys a greater assurance of success compared to what they could deliver on their own.

Cost Reduction

This is the number one reason why firms consider outsourcing. However, while important, it's not usually the number one concern of firms that understand the value of withholding tax. The big benefit that delivers cost reductions is in the removal of hidden internal processes. Even if you have a software system, some significant proportion of the process is manual and, for financial services as we all know, manual is bad. Outsourcing allows firms to convert a costly, semi-manual error prone process into a straight-through processing (STP) function. In a well benchmarked STP environment, clients send a file one way and receive funds and reports electronically in the other direction. And from their viewpoint, that's pretty much all there is to it. All the manual elements of the process, indeed, all the elements of the process, are opaque. Information flows one way, money flows the other way and that's exactly what fund managers, custodians and investors like.

Compliance

If you can't produce an accurate assessment of a client's recoverable tax or eligibility for relief at source correctly the first time and every time, you stand a good chance of falling foul of regulatory compliance. How many headlines have you seen in the past few years of heavy fines being issued for failure to keep and maintain accurate client records? It's these very records that underpin the assessment of eligibility.

The idea of outsourcing a function to minimise compliance risk may seem paradoxical. However, the number of regulations now in force that evidence some sort of extraterritorial jurisdiction gives corporate actions departments and compliance officers, nightmares. Outsourcing, in a functionally selective way can actually reduce the burden on compliance and operations departments by releasing them from some proportion of concern over whether they have their structures integrated and monitored. It then becomes the job of the outsource partner. The benefit is that the accuracy of the underlying data is critical to the outsourcer's business, because it is its only focus.

Corporate Governance

Financial services firms face two corporate governance issues, not one: their own governance, usually overlooked by regulatory authorities, and the corporate governance of their clients. Investors are becoming increasingly proactive and holding their investments long as the balance in yield strategies changes. The result is that more are receiving dividends and being over-taxed. Typically, two institutional investors with different residencies may be taxed, and therefore over-taxed differently. If the CFO of the invested company does not take action, his investors lose money. Similarly, if the custodian fails to act, the investors may lose money. The publication in 2003 of proxy voting policies on probity in withholding tax evidences the pressure on the investment management chain to demonstrate that everything possible has been done. Investor concerns should make custodians and fund managers consider outsourcing more strongly to demonstrate best efforts on behalf of their client's underlying shareholders.

Competitive Advantage

Most relationship managers would happily enter a pact with the devil if they could get a legitimate and clear service advantage in the market and withholding tax is one such. Unfortunately, when taken at the fund management or even custodian level the internal costs are so high that profitability is difficult to achieve so many either don't address withholding tax at all, do so inconsistently or have policies that disenfranchise some clients. Outsourcing allows the creation of a profitable withholding tax service, which is complete and inclusive for all clients and converts a fixed internal cost into an external, variable and contingent one.

How to Outsource

Spend your time finding out whether you can trust your potential partner and not whether you think his process is better or worse than yours. Trust is built up in a number of ways. What's the financial position of your partner? Who uses them? Take up references and pay attention to the tone as well as the words used in references. What does your partner put back into the industry and into your business in particular? Is he looking after your interests and your clients or just processing data? How does he go the extra mile? Trust is the key that opens the door to successful outsourcing.

Make sure your end result is as straight-through as possible by making it all about file transfer from your viewpoint. This can be achieved in less than half an hour with good client IT support. How - because if your partner is processing over a million reclaims a year, they have to be able to do that, it's their business to make the transition smooth and efficient. The result the client sees is electronic files out and money and electronic reports in.

When to Outsource

While withholding tax is a seasonal business, outsourcing takes only a few weeks to implement. Full transition (the big bang) can of course be done between dividend seasons to allow the same stabilizing process, but given that the result is essentially a data feed out and account credits in, there is actually no reason why big bang cannot occur at any time. This is because of Statutes of Limitations. If initial analysis shows significant sums about to fall out of Statute, big bang is not only feasible, it's preferable to avoid potential liabilities later on. Whether big bang or phased introduction is selected, the Statutes typically give

several years in which reclaims can be filed so whatever is handed over is not usually mission critical. Having said that, best practice benchmarks this activity at less than two weeks from notification of income to filing of tax reclaim. In summary:

Outsourcing is something everyone is already doing and has been doing for years.

Outsourcing withholding tax is about a change of degree, not kind;

Outsource for *several* good and solid reasons;

Choose someone you can trust, that knows the difference between a partner and a supplier and can prove it;

Choose someone whose business volumes demonstrate the basic principle of outsourcing efficiency;

Choose someone whose reputation in the market stands testament to the fact they'll still be there in ten years.

Check benchmarks. International benchmarks for withholding tax processing were published by Euromoney Institutional Investor in 2003;

Make it STP from *your* viewpoint.

There is no real timing sensitivity or seasonality to outsourcing withholding tax - how fast do you and your clients want to realise the benefits?

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