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## [Tax Reclamation: Helping to Close Pension Funding Gaps](#)

*By William Treut*

Many defined benefit retirement plans are facing actual or potential underfunding. This is due to a combination of excessive portfolio return assumptions, losses in portfolio value from the market downturns of recent years, strains on governments' budgets and the emergence of the Baby Boom generation into pension collection mode. This situation has wide-ranging ramifications for the pension fund model, not to mention the effect of reduced retirement security for plan participants anticipating the collection of defined benefits.

The outgrowth is also a harsh reality for fund managers and advisors. They have to find new ways to generate returns or reduce operating costs. In addition to reducing costs, fund managers can also increase fund returns by actively managing a program of reclamation of foreign tax withholdings on cross-border investments. While the pension plan's custodian is often best placed to perform this service, the performance of tax reclamation among custodians is decidedly mixed. In the event that a custodial bank is not performing this highly manual and complex task to a significant degree of success, the fiduciary burden of tax reclamation falls to the pension's trustees to ensure that someone is monitoring the cross border investment income to continually file the ongoing reclaim applications.

Generally, the arcane subset of knowledge of process and various rules necessary to manage an ongoing tax reclaim program is beyond both the investors themselves, as well as the other most obvious provider of tax advisory services, namely the investors' CPAs. At this point, the choice the investor is left with is fairly stark and amounts to either a) leaving the money on the table or b) hiring one of a very limited number of experts to perform this work on their behalf.

### Foreign Investment Income and Performance

Pension funds, no matter their location, are often able to retain maximum levels of earnings for the benefit of the funds' beneficiaries, thus eliminating the need for additional government or member contributions to cover taxes on earnings. Under most double taxation treaties, pension funds as tax-exempt entities in their home markets are similarly viewed by overseas governments as not liable for taxation on investments in their countries.

However, due to the lack of transparency to foreign government tax authorities within the custody chain, tax-exempt investors often do not receive exemption from withholding on their investments abroad. The same benefit is often also extended to charitable endowments or foundations.

Given that beneficial owner identity is only rarely able to be made readily available to foreign tax authorities due to the way shares are held within the frame work of global custody, portfolio earnings are generally subjected to withholding at maximum statutory rates. In most applicable cases, the avenue available to obtain treaty-based entitlements is to avail oneself of reclaim processes put in place by the foreign tax authorities. Reclaim applications may generally be filed from the time of dividend payment and up through a statute of limitations period, usually a multiyear filing period that is typically two to five years after the income event, depending on the country of investment. If no reclaim application is filed by the date of expiry of the statute period, the right to reclaim will expire.

By not acting to put into place a process to obtain refunds of tax withheld on foreign investment income, a fund is effectively choosing to make a donation of investment earnings to a foreign government. Such actions are certainly not in the interests of the fund's participants. One could easily construe such inaction as a breach of fiduciary duty to act in

the best interests of the beneficiaries of the plan. Given that much if not all of the withholding can be recovered for many pensions, the impact on investment performance can range as high as 50 to 100 basis points annually. At that level, the activity can provide tremendous long term benefits for the fund and its beneficiaries.

### Recovering Foreign Tax Withholdings

To recover the tax withheld on foreign investment, a fund beneficiary or the beneficiary's advisors or custodians can contact providers of withholding tax related services in the investment community.

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