

Withholding Tax Issues Rank High On Corporate Agendas

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Withholding tax finally hit the front pages in 2004. Well, maybe not the front pages of the national media, but certainly the front pages of more investment agendas than ever before. Why is this? Well it certainly isn't because everyone realized how much value they represent and have been missing all these years. Estimates of the amount of withholding tax still sitting in foreign government's bank accounts vary widely but are always in the billions of dollars every year with Statutes of Limitation compounding the potential loss for investors. For the securities industry, it's historically been more to do with awareness at one end and the spiralling costs of keeping up to date with what is a very complex area of securities processing at the other. It's also becoming a governance issue, a risk & liability issue as well as a service opportunity not to be missed.

Three of the most common reasons that so much tax goes un-recovered are (i) the nature of the securities, (ii) the nature of the investment vehicle and (iii) the, often false, presumption that someone in the investment chain is actually trying or able to recover the tax in the first place. Foreign governments will withhold tax from income generated in their countries at a high default "withholding rate" unless they have reason to know from the beneficial owner of the securities or someone acting on their behalf, that the ultimate non-resident beneficial owner is entitled to a lower treaty rate.

From a securities viewpoint, the typical example is in Depositary Receipts. The fact that the ADR as a security is a one-to-many relationship to the underlying foreign ordinary shares merely complicates the matter further for the owner who has to factor in the ratio of the ADR itself to the underlying ordinary shares. Holders of ADRs and their custodians, if they process reclaims on these positions, must frequently use a different process and claim tax back from the sponsoring issuer and not the foreign government.

Investment vehicles can cause similar problems, usually revolving around how the foreign government views the vehicle – transparent or opaque. Most pension funds are opaque to foreign governments. In other words, the government does not need to know who the underlying members are, nor their residency or status. The entitlement to any reclaim is at the fund level. Hedge funds on the other hand are usually transparent. That means that a government will not allow tax reclaims at the fund level, it only permits reclaims at the underlying partner/member level.

Keeping track of all this is a major challenge to most members of the investment chain, not least because tax recovery is just one side of the withholding tax coin. Lack of knowledge or understanding at one end is matched by high costs at the other where the expense of keeping up to date with changes that apply across large multi residence, portfolio based client bases causes headaches for compliance and risk functions as well as operations. Even those who are participant members of the Depositary Trust Company, who have access to the Elective Dividend Service (EDS) and can therefore obtain relief at source, can face daunting problems calculating their client's eligibility and positions before registering their various entitlements.

Withholding tax hit the Corporate Governance agenda in March this year with guidelines based on the principle that right at the beginning of the investment chain, is where action needs to start. Directors of companies with cross border institutional share ownership are feeling the effects of general corporate governance guidelines that require them to be more transparent. These general guidelines translate into specific guidelines requiring directors to at least raise awareness of the effects of withholding tax on their shareholders to a greater degree than before and, in best practice, actually make sure that shareholders are not differentially treated without knowing about it.