

Cross-Border Tax Reclamation: Maximizing Dividend Yield

By Martin S. Foont

When your clients invest internationally and receive dividend income on their holdings—either ordinary shares or American Depositary Receipts (ADR)—that income is often subject to withholding by the government of the issuer's jurisdiction. The same income may also be subject to U.S. tax. To mitigate double taxation, pairs of countries have entered into double taxation treaties: investors may be entitled to reclaim all or part of the withheld foreign tax. The burden of proof, however, falls to the investor to present evidence of residency and proof of security ownership on the dividend record date. The application process entails completing, signing and filing the appropriate country-specific forms and paying any applicable fees. All this must be completed, error-free, within the statute of limitations for the investor to avoid forever losing this entitlement. Tax reclamation is a complex and highly manual process.

Entitlement rates and recovery speeds vary greatly and depend on numerous factors, including beneficial owner entity type, year of dividend and the residency of the investor and country of investment. The administrative procedures involve a complex network of custodians, withholding agents, brokers, depositaries, central securities depositories and in-country agent banks. Tax treaties, tax laws and filing requirements also vary from market to market, and are subject to frequent change. Errors can be costly, as the smallest mistake may result in a claim being rejected.

Most investors, including many institutional investors, do not have the knowledge or processing infrastructure required to identify entitlements and successfully reclaim over-withheld tax on their own. Generally speaking, this must be done in cooperation with the investor's bank or broker, and the custodian of the assets. Some custodians support a "relief-at-source" process for their clients, where the proper withholding rate is applied at the time the dividend is paid. Relief-at-source processes, however, are only available in certain markets and the requirements for participation vary. As a result—in many instances—the investor suffers excess withholding, but is entitled to "reclaim" those funds. Due to the complexity described above, and the difficulty in managing these processes, most of this money goes unclaimed and is essentially forfeited to foreign governments.

IRS Compliance Issues

One common misconception is that an investor can simply take a tax credit for the withholding. This is only partially true. The instructions for taking a foreign tax credit on [IRS Form 1116](#) state:

"You cannot take a credit for the following foreign taxes. 1. Taxes paid to a foreign country that you do not legally owe, including amounts eligible for refund by the foreign country. If you do not exercise your available remedies to reduce the amount of foreign tax to what you legally owe, a credit for the excess amount is not allowed."

In other words, *a foreign tax credit is only allowed for the non-recoverable portion of the withholding*; thus, taking a foreign tax credit for withholdings that could have been recovered if the investor filed a reclaim is not permitted. As tax-exempt investors generally do not pay taxes in the United States, they would not have an opportunity to benefit from a tax credit.

But investors who are eligible and engage in tax reclamation for the first time may find they often receive a "windfall" based on prior years' excess withholdings that are still within the statute of limitations to be claimed. Statutes of limitations vary by market but generally range between 2 and 6 years.

Special Considerations

ADRs, which are the mechanisms with which foreign shares are traded on a U.S. exchange, present a challenge to investors who are often unaware that they have an entitlement because they did not buy the shares in a foreign market. Investors who buy ADRs, however, have the same issue of withholding at source and the need to file a tax reclaim

application. The only difference is that these depositary receipts represent the underlying ordinary shares at a specified ratio. Because the shares are owned by a depositary that has issued the depositary receipts, the reclaim must be filed through the institution that issued the ADRs, so they can file a claim with the foreign tax authority. Banks and brokerages perform this function for their clients to varying degrees, often based on the level of requirements for filing in each market.

Hedge funds generally need to address this issue themselves because their custodians (often a prime broker) rarely perform it for them for two key reasons. First, in some markets the reclaim application must contain information about the ultimate beneficial owner of the shares (i.e. individual partners in the fund) and most funds are reluctant to share the identity of their partners with the prime brokers. Second, prime brokers do not typically have personnel dedicated to the manual and cumbersome reclaim filing process, nor the resources to file and follow up on foreign tax reclaims. If a hedge fund does not use an outside service provider to file tax reclaims, not only will they suffer statutory withholding rates in virtually all markets, but they will likely never receive the full amount entitled to them and their partners.

No matter the situation, tax reclamation serves as a powerful tool for enhancing portfolio performance; yet, due to the highlighted aforementioned complexities, most entitlements expire unclaimed. With a little work, though, it doesn't have to be this way.

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