Contending with Pension Deficit Disorder

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Members of the GlobeTax team spent three days at the National Conference of Public Employment Retirement Systems' (NCPERS) Annual Conference & Exhibition. There, trustees, investment officers, and service providers gathered to discuss the current state of public defined benefit (DB) plans and highlight ways to improve portfolio outcomes in an uncertain world of funding gaps and looming deficits.

GlobeTax Director of Sales Tom Grande delivered a presentation about one such performance-boosting strategy: withholding tax recovery. In synthesizing insights from the conference, the team concluded that many pension investors enjoy untapped, yet significant, opportunities for recovery– especially compared to those investing through self-directed DC plans like IRAs and 401(k)s. The pension advantages come from scale, fund structure, and fiduciary duty.

The Scale Advantage

Advocates of defined contribution (DC) plans often cite ~70% funding gaps to argue for abolition of DB pension plans and adoption of a 401(k) type system. While acknowledging this line of reasoning, author David Webber levied a powerful counterargument during a lunchtime speech: the scale of pension funds.

As collective, centrally-managed organizations with significant purchasing power, pensions enjoy leverage that atomized 401(k) or IRA investors do not. They can lobby corporate boards or congressional bodies for policies favorable to workers, retirees, and investors. By flexing their critical mass, they can negotiate with service providers for competitive fees and secure flexible investment structures like group trusts or SMAs. Together, all of these activities can lower costs and enhance yield for their investor population(s).

Pensions also enjoy advantages of scale for asset services like foreign withholding tax recovery. Under the terms of double taxation treaties, investors are eligible to reclaim over-withheld taxes on foreign investment income – if they can demonstrate they are residents of a treaty country. To provide such proof, investors must secure Certifications of Residency from their home tax authority. In the United States, officially-issued IRS Certifications cost $85 and must be re-requested each year. In addition to the Certification cost, other counterparties in the custody chain charge fees to process claim applications. Because of these costs, withholding tax recovery providers will often set a minimum claim threshold. If the recoverable amount is under a certain value, it is not economically viable to pursue tax recovery, leaving smaller investors without any recourse.

Even the largest IRA accounts own smaller positions in foreign companies than do pensions, whose AUMs span from tens of millions to tens, if not hundreds, of billions. As a result of their small position size, individuals often fail to meet the minimum claim threshold and are thus deprived of recovery opportunities – opportunities which would have been granted had they been invested within a larger pool of assets.

The Structural Advantage

In instances where a DC investor amasses portfolio with viable reclaim opportunities, they often receive sub-optimal tax treatment because of the way their investments are structured. Typically, participants in company-sponsored 401(k)s must invest through a finite pool of pre-vetted mutual funds. While this constraint has benefits- diversification, simplification, and low operational costs- these advantages come at the expense of advantaged foreign withholding tax rates.

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Why? When mutual funds apply for tax reclamation, they submit claims at the "fund" rather than "beneficial owner" level. This fund-level categorization is constraining. Under double taxation treaties, mutual funds are considered "taxable" rather than "tax exempt" entities– even if their underlying holders are investing through retirement accounts or other tax-advantaged structures.

Whereas tax exempt entities can recover 100% of over-withheld foreign tax in most markets, taxable entities can only recover a portion of withholdings. In other words, if assets were managed through a DB plan, plan participants would receive the tax exempt rate (assuming proper administration by the DB plan sponsor). However, because they are invested in mutual funds through a DC account, the beneficial owner will suffer the higher rate, resulting in lower portfolio performance.

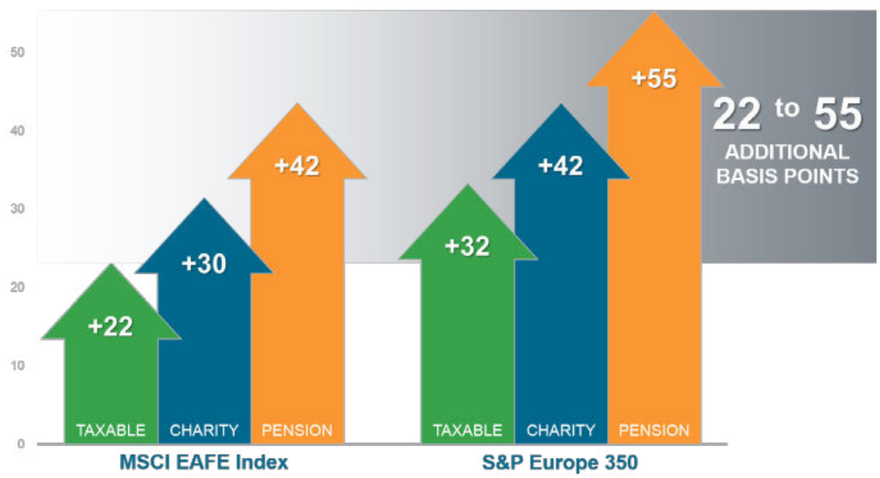
The Fiduciary Advantage

Fiduciary duty is an additional factor favoring DB over DC investors seeking tax reclamation. Bound by a fiduciary standard of care, pension funds are obliged to pursuing all possible avenues to maximize portfolio performance – withholding tax recovery included among them.

Mutual funds, by contrast, do not share this obligation. Even when fund management companies do pursue tax recovery services, they receive unfavorable tax rates, as noted above. In instances the fund managers opt not to pursue recovery, the burden defaults to other parties in the custody chain such as the prime broker or custodian. Although such intermediaries might offer the service to investor clients, there is no guarantee or requirement that they do.

Defined Contribution vs. Defined Benefit: The Final Tally

Ultimately, there are merits and drawbacks to both defined contribution and defined benefit systems. Fortunately, foreign withholding tax recovery is available to savers through both plans. But, as the NCPERS conference powerfully demonstrated, in the instance of tax recovery, the is scale is tipped toward DB participants. Pension investors have access to scale, favorable fund structure, and fiduciary duty that defined contribution account holders simply cannot match.



The image summarizes the benefits available to pensions versus other entity types. Reclaimable value estimates are based solely on the reclaimable value calculated using dividend events, as received by an ETF modeled on the specific indices over a one year period, December 2016 – December 2017.

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