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THE REGULATORY FUNDAMENTALS GROUP LLC

# **Leaving Money on the Table? How to Reclaim Foreign Taxes**

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*The following are notes from a conversation between Tax Withholding-expert Len Lipton of GlobeTax and Deborah Prutzman from RFG. Mr. Lipton's bio can found here: <https://www.globetax.com/Team.aspx#lenlipton>.*

**Deborah: Len, can you tell us how cross-border investment tax withholding and how various statutory regimes differ?**

**Len:** When an investor receives dividends or interest payments on foreign securities, the cross-border income is often subject to local withholding tax prior to leaving the foreign jurisdiction. The reason for this is that the local paying agent in the market where the issuer resides has little or no visibility through the custody chain, which would allow them to identify the ultimate beneficial owner (and therefor determine the correct withholding payment). As a result, the withholding typically defaults to the highest rate allowed by law – called the ‘*Statutory Rate*’.

Many investors are subject to additional taxation once they have brought that money back into their home country due to their local obligations -- hence, the investor is paying tax twice, a double tax, on the same income to two different jurisdictions.

Governments understand that this is happening and that the double taxation has a negative effect on investment returns. Those governments still want to attract investments into their country and know that in order to do so they need to mitigate some of the double tax burden. As a result, pairs of countries enter into treaties with one another, which provide for favorable rates of taxation when the residents of one country invest into another – these are called, “*double taxation treaties*” and are usually reciprocal.

Some of these treaties are negotiated in such a way that tax-exempt investors may be afforded full exemption from tax in the market in which they’ve invested. However, the investor in many cases will be over-withheld at the time of dividend/interest payment. (Thus, leaving money on the table.)

**Deborah: What is the process to claim these back?**

**Len:** This can be very complex because each market has its own nuances and application forms, sometimes these are in local languages. In all cases, however, claimants must prove their legal tax residency and provide evidence that they owned the security in question over the relevant record date.

Generally, the custodian must be involved as evidence usually includes documentation from the legal paying agents, which they are in a unique position to provide. In some instances claims are made directly to the tax authority in a particular market, in other cases claims must be filed through local agent banks (a.k.a. *sub-custodians*) who sometimes assess fees to issue requisite documentation.

**Deborah: How difficult is it to do yourself?**

**Len:** You can do it yourself; typically in this case the custodian will drive the process. The problem is that most custodians will only send out a one-time notice asking for information. This request, often only given once, is frequently overlooked. ***The biggest mistake investors make is assuming that somebody else is doing the work for them.***

There are many moving parts to tax reclamation. Application forms and document requests change frequently, as do treaty rates and statutes of limitations. There are also often different treaty rates for different beneficial owner types, such as individuals, endowments and pensions.

Also, the reclaim process is often unique to each income event (dividend or interest payment) and claims must often be lodged individually on that basis. This compounds the problem because documentation (often original documentation) must accompany each claim.

The reality is, if an investor has one or a very small number of claims to do every year, they *might* be able to effectively manage it themselves. However, once the number of items per year increases and/or the number of countries involved increases, the complexity compounds significantly.

**Deborah: How much do you need to have before a third party would take this on?**

**Len:** GlobeTax will file reclaim applications once they exceed our threshold of \$100 in net benefit to the client. Anything below that generally doesn't make financial sense given the fees applicable to the process. Those fees include government certifications, processing fees to financial intermediaries and payments to couriers (FedEx, etc.).

GlobeTax monitors client portfolios at no cost, essentially serving as a free backstop in the event actionable reclaims arise. As a general rule of thumb, GlobeTax tells potential clients “if your portfolio consists of at least \$1,000,000 in cross-border securities, you’re likely a good candidate for our services.” At that level, it is likely that the client will receive somewhere in excess of \$1,000 to \$1,500 a year. GlobeTax operates on a contingency basis and only receives a fee if a client receives payments.

**Deborah: What to ask your third party service provider:**

**Len:** You need to understand the service provider’s expertise in the tax reclaim space. Questions to ask include:

- How long have they been doing this?
- Is it their core competency or a peripheral line of business?
- Do they have personal relationships with the various tax authorities? How many claims do they file in a given year and what is the make-up of their client base?
- Do they have relationships with your custodian(s)?
- How is data received and validated? Is it an automated process or manual?
- Does the service include full document management including Residency Certification fulfillment?
- Do they monitor treaty changes?
- Do they have an internal research team?
- Do they subscribe to an external database?
- What is their fee structure?

Also, understand their investment in data security and request client references.

**Deborah: Proposed changes in laws, regulations or treaties to be should be aware of:**

**Len:** Treaty rates, and to a larger degree, documentation and disclosure requirements are changing all the time, often with little or no notification. In addition, there are maturing markets that are developing processes to honor existing treaties, where, in the past there was no mechanism to secure your entitlement. Russia, Israel, Romania, Poland and the Philippines are a few examples.

The trend we're seeing in tax reclamation is clearly towards greater disclosure, particularly with partnership or common trust structures, as foreign governments increasingly want to understand who the ultimate beneficial owners are that reside within such vehicles.

There is one item that may be of interest to endowments and foundations having to do with changes in partnership law in the Cayman Islands incorporating some of the elements of the Delaware partnership law that make Delaware vehicles so attractive. These have to do with rights afforded to both the limited partner, as well as the general partner. Subsequent to passage of the recent Limited Partnership law, there is legislation being considered for a new vehicle type called an Exempted Limited Liability Company or ELLC.

The ELLC is modeled largely on the Delaware legal structure. The ELLC has some very positive side effects as it relates to the withholding tax drag that investors can be subject to when investing through an offshore vehicle.

The idiosyncrasies of the US tax system subject tax-exempt investors to Unrelated Business Income Tax (UBIT) based on gains generated from borrowed money. Many hedge funds regularly 'short' stocks which requires the seller to first borrow the securities. Other hedge funds regularly leverage their portfolios, using margin to increase the investment exposure. Both activities can create tax implications for tax-exempt investors.

To solve this issue, tax-exempt investors can invest into a foreign feeder fund which is structured as a corporation and thus the investors are not exposed to the leverage activities as direct participants. That means the beneficial owner of the security is the Cayman Corporation. Those investors, because they are in a corporate vehicle cannot gain access to treaty rates which are so beneficial to tax-exempt entities. If an ELLC structure was employed instead, those investors (or at least the ELLC itself) should have the ability to file for reclaims into many markets from which they had suffered excess withholding tax. GlobeTax is watching this closely as it could have a very positive result for many clients.

**Deborah: What to ask when entering an investment or allocating to a fund:**

**Len:** What, if anything, do they do to recover over-withheld cross-border investment income? If the answer is nothing, that's investor money left on the table. If the fund has a significant allocation of their portfolio in dividend paying foreign securities, that could translate to 25 basis points or more from performance.

Investors should consider the tax reclaim aspect of their investment performance when talking to managers about the fund structure in terms of whether the structure would allow for tax reclamation and if not, at least be comfortable that the structure in place is not just because the fund's attorney said, "we always do it that way..."

Once the ELLC structure is adopted, a due diligence question may be whether the manager/fund intends to use it.

**Deborah: How long does it take to recover the funds?**

**Len:** Recovery time varies by market. On the short-end, you can see money come back in 4-6 months, on the long-end 18-24 months. On average, recovery time runs about one year. Although there have been some improvements of late, Italy remains a notable outlier, as they have historically taken 5 years or longer to pay.

**Deborah: What is the Statute of Limitations on filing claims?**

**Len:** Similar to the last question, it varies by market. The range is 2 to 8 years, with most markets falling into the 3 to 5 year range.

**Deborah: Why won't a custodian/prime-broker handle this for its clients?**

**Len:** In some cases they do. Some perform tax reclamation better than others but nobody does it perfectly.

In the hedge fund space, none of the prime brokers perform these services as it's not part of their offering and their fund clients generally aren't willing to disclose the names of their LPs to them.

**Deborah: Can't an investor take a tax credit for foreign tax paid?**

**Len:** It depends. Tax-exempts, by nature, do not pay taxes so, wouldn't have an offset anyway. That said, tax-payers, according to the instructions for IRS Form 1116, cannot take a tax credit for taxes paid to a foreign country that they do not legally owe, including amounts eligible for refund by the foreign country. In other words, 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. While historically, many high net worth investors have done this, the IRS has recently signaled that not only are they aware of the issue but that they may look to enforce it as a point of audit.

**Deborah: Does GlobeTax sign forms on the client's behalf?**

**Len:** Yes, mostly. There are certain instances when GlobeTax (or another service provider) cannot sign a form so we will have to reach out to our clients. But by and large part of the sign up package with GlobeTax clients is that they empower and appoint GlobeTax as their legal agent to do most things on their behalf.

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