International Withholding Tax
The Responsibilities of Issuers to Foreign Shareholders

A paper on corporate governance policy and best practice for senior executives

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Introduction

In this white paper, Ross McGill examines what expectations shareholders and boards of directors should have of each other when it comes to distribution of dividends cross border.

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Summary

When a board of directors submits a resolution to an Annual General Meeting for the distribution of a dividend, there is a reasonable expectation by all the shareholders that they will receive the value that the company intended them to receive. Yet, in reality this all too often does not occur.

Rapidly increasing volumes of cross-border share ownership is creating a two-class community of shareholders from the corporate perspective, resident and non-resident, which is likely to affect long term cross border investment strategies of institutional investors. Due to over-taxation at the point of distribution and failure by many in the investment chain to deal with the issue effectively, the latter may ultimately receive up to 35% less value from a corporate dividend than that to which they are entitled and which the board of directors intended that they receive.

While companies are not legally responsible for the tax affairs of their shareholders, they *are* responsible for maximizing share value and fundamentally interested in attracting and maintaining investment. This requires transparency and best practice as supported by Sarbanes-Oxley in the USA, Higgs in the UK and other governance frameworks in development across Europe. Their ability to attract investment is thus closely linked not just to their performance as a business but increasingly, their performance towards their shareholder's interests. It is therefore in the best interests of companies with cross border shareholders, to adopt transparent, shareholder friendly policies to encourage investment.

Shareholders are the net losers at present. The withholding tax industry is highly fragmented in its knowledge, application and consistency in the support of shareholders. Shareholders should place pressure on boards of directors, through the application of corporate governance policies and voting, to require such boards to:

(i) know about the effect of withholding tax as it pertains to their non resident shareholder base,
(ii) facilitate the education of their shareholders about the material effects of their decision to invest in the company and
(iii) provide access to solutions which can mitigate any loss in return on investment that would otherwise occur.

Background

Increasing international share ownership

There is an increasing trend in cross border share ownership at both individual and institutional levels. Where shareholders may have different legal status and also different countries of residence, this brings additional complexity to the board's ability to deliver shareholder value without adversely impacting one group or another.

It is reasonable for a shareholder, when investing in a company, to expect that the company's directors will deliver shareholder value in equal measure to *all* members to the best of its ability, irrespective of their status and residence, wherever possible.

Withholding Tax

There are two methods whereby a company can deliver shareholder value. Increase in share price and distribution of dividends. In the latter case, a dividend distribution to a shareholder can be significantly impacted dependent on the legal status and country of residence of the shareholder.

In cross border distributions, the withholding agent bank of the company concerned must remit a proportion of the dividend in tax to its local tax authority. The rate at which such tax is levied - The Withholding Rate – is applied generically without favour.

Double Taxation Agreements (DTAs)

Double Taxation Agreements, where they exist between pairs of countries, provide for a "Treaty Rate" of withholding tax, usually lower than the withholding rate.

While the treaty rates agreed between pairs of countries may give an *entitlement* to a lower rate of tax, recipients must provide evidence of entitlement in order to access such rates.

Where shareholders are *registered* there is a higher likelihood, although not certainty, that through the registrar, any manager of the shareholder's assets will have sufficient information to either have the lower treaty rate of withholding applied at source, or failing this, be able to recover the difference between the higher withholding rate and the lower treaty rate, remedially. For bearer shares, there will be no easy record of the status or residency of the shareholder, so a remedial tax reclaim is the only solution, if it is applicable.

Statutes of Limitation

Many tax jurisdictions in which issuers have their corporate residency provide time limits during which claims for tax can be filed. Most foreign shareholders will be unaware of these Statutes.

Statutes have two effects. The first is to provide the ability for the shareholder to go back in time over previous dividends distributed by the company and file for recovery of any over-withheld tax. The second, on an ongoing basis, provides time for the shareholder to file any claim.

Most shareholders have very little knowledge of domestic, let alone foreign tax law and regulation. In this instance it is best practice and should be policy, for the directors of issuing companies to make their shareholders aware, not just of the issue of withholding tax, but also the impact of Statutes of Limitation both historic and ongoing.

The Practical Effect

In a typical example, a US investor in a Swiss company will have 35% of their gross dividend deducted at source by the issuer's withholding agent bank and held by the Swiss tax authorities. If the US investor is a pension fund, they are actually entitled to the whole 35% back from the Swiss government. Even if not, they are still entitled to 20% back under treaty. This is bad enough and unacceptable if it is being missed. What compounds the situation is that, in this example, as is typical of several countries, the US investor would still be entitled to recover this level of tax for *each and every one of the three previous years* since the end of the year in which the original dividend was paid.

The question is, on the one hand, should the company, to sustain its reputation as a good investment vehicle, make the US investor aware that his investment returns will be 35% lower than he expects as opposed to other domestic shareholders, or, on the other hand is it up to the issuer to know such things as a matter of course. While short-term thinking would result in the latter course of action, there is no doubt that those companies that adopt a more proactive approach to getting the best for their shareholders, will attract and retain investment more readily.

It will not be long before the effects of Sarbanes-Oxley and of Higgs stimulate governments to add regulated requirements on issuers to deal with cross border impacts on investors thus underpinning what should currently be best practice.

The Custody Chain

Ownership of shares is rarely a simple process in terms of safekeeping of assets and management of investment income. A variety of firms can be, and often are, involved in the process. Complexity is caused as institutional shareholders do not arrange ownership and thus management of shares in any one company and also hold different parts of their portfolios through different intermediaries or custodians. In other cases, complexity is caused by the commercial relationships between custodians themselves who, in order to provide a cost effective service in several countries, contract with other custodians to provide subsidiary or country based "sub-custody" services.

Thus, when companies elect to distribute dividends to shareholders, there can be several intermediaries in between the withholding agent representing the company and the final recipient (shareholder).

While it is clearly in the interests of such custodians to both know of the issues facing shareholders who do not reside for tax purposes in the same country as the issuer (non-resident shareholders), the degree to which custodians actually have knowledge of withholding tax and implement such knowledge varies widely.

There are currently no industry wide policies to guide boards of directors as to the selection of custodians such that they may be assured of a proactive approach to withholding tax and thus the best treatment of their shareholders.

Many shareholders, particularly institutional shareholders, use intermediary custodians as asset managers, however, while estimates vary, it is clear that only a fraction of over-withheld tax on investment income is ever recovered.

Responsibility to Know

Custodians & Intermediaries

With only two exceptions, no organisation in the custody chain has direct responsibility to advise shareholder's on their eligibility for lower taxation rates unless the organisation has contracted to provide such advice or where they have, for marketing or commercial reasons, a motive to offer such advice.

The two parties who do have a direct interest are the shareholders themselves and the board of directors whose direct responsibility it is to perform the wishes of the shareholders.

There is debate as to the legal position of many custodian intermediaries in this context. Both companies and shareholders rely on intermediaries in many ways as "experts" whether direct or indirect, explicitly or implicitly. There are many shareholders who still have a valid entitlement to recover over-withheld tax on investment income received cross border, who will never receive it, never have received it in the past, and will, without action, continue not receiving their entitlements in future. The question is, to what degree should a shareholder or company expect their financial agents to tell them what they don't know and to what extent is there an implied duty on the intermediary as the "expert" to at least make the parties aware of the significance of the issue, if not provide a solution.

It's clear that there are two issues here. First is the implied duty as a deemed expert to bring an issue to the attention of the parties concerned. The second is to actively do something about it. The latter is clearly a commercial issue based on whether the intermediary has the requisite skills, knowledge and experience to recover this tax on behalf of its clients, in the face of competition from other intermediaries who do have such an appetite.

Even in the absence of specific contract terms in this regard, the company and its directors may reasonably assume a level of responsibility on the part of their custodian(s) as the "experts" in the field. However, this assumption has no legal precedent – yet. Given the truly enormous scale of the issue for the larger institutional investors, including mutual funds and hedge funds, it may not be long before losses in un-recovered tax accrued over many years and an intermediary custodian who has failed to educate or facilitate a solution, may be placed before a judge to decide whether there is an implied or fiduciary duty at custodial level, irrespective of contract terms.

Companies

All governance related law and regulation stand testament that directors are being held increasingly accountable in regulation and law, for failures to meet the expectations of shareholders. So it would seem reasonable to expect that a board of directors with an international shareholder base, would ensure that they were aware of any material issue that might affect their shareholders. Withholding tax, in this context, is clearly such an issue.

Companies often argue that the personal status, residence and tax affairs of shareholders are their own business. However, the issue of responsibility to know centres on the expected level of knowledge of issues such as withholding tax and the degree to which such knowledge, and its impact, is disseminated.

Because the effect of withholding tax is so significant and so material, neither shareholders nor directors can in future avoid knowledge and action.

From the company's perspective there may be an implied duty on directors, and particularly directors with financial expertise to at least advise those who have parted with cash in return for membership of the issuing company of the implications of such ownership. Those companies with a diverse and widespread shareholder base may also consider it prudent to go beyond educating their shareholder base about the existence of such issues and seek to provide positive methods to assist their members minimise the tax liability which has resulted from their investment in the company.

Summary Disclosure Guidelines

The issue of recovering tax from tax authorities is extremely fragmented and inconsistent. The problem for companies and for their shareholders is that no-one in the direct chain of investment is making the scale of this issue sufficiently open or clear. This means that there are shareholders unaware of their entitlements and companies unaware of the potential downside risk from their differential treatment of resident versus non resident shareholders.

This could be avoided and brought to public awareness through the forced disclosure of some basic facts by both companies and by institutional shareholders e.g. mutual funds, pension funds etc.

A company should disclose:

- the proportion of total shareholding held by non-resident persons segregated by country of residence and by status of beneficial owner
- at annual general meeting, as supporting documentation to dividend resolutions, the effects of withholding tax on non-resident shareholders, by country of residence and status, detracting from the gross dividend declared

These disclosures will ensure that companies make all shareholders aware of the non-resident taxation issue at an early stage so that they can take action on its recovery.

A fund should disclose:

- the proportion of its assets held cross border and the income derived therefrom, segregated by country of investment;
- whether the fund is eligible for relief at source and if so, whether such relief at source has and is being maintained on income received;
- whether over-withheld tax has been, or is in the process of being recovered and the proportion this represents of the total recoverable tax
- the proportion of asset value represented by recovered tax

These disclosures will enable members and trustees of a fund to establish both the scale and scope of the withholding tax issue it faces and also the performance of the trustees in maximising fund value on behalf of its members.

Summary Policy Guidelines for Companies

Prior to such disclosures, there are policies that companies could adopt to demonstrate their support for their international shareholder base. These principles and policies will ensure that effective education takes place and that the two most interested parties have the knowledge and tools at their disposal to maximise their investment, reputation and governance.

Principle:

Boards of companies with an international shareholder base should ensure or facilitate, as far as is practicable, that shareholders not resident in the country of incorporation, are, as far as practicable, not disenfranchised from the intent of the board in declaring any particular dividend value, by virtue of their non-resident status.

Policies:

1. No shareholder will be disenfranchised from any portion of value delivered to him by the company by reason of his residency in a country different to that of the company's incorporation.
2. The Board of Directors will adopt one or more strategies to enable shareholder value to be maximised:
    a. Education – to provide greater awareness of the impact of cross border investment strategies for shareholders;
    b. Facilitation - to provide access to shareholder solutions for provision of relief at source or recovery of over-withheld tax
3. Where facilitation takes place by the board, the commercial terms on which such facilitation takes place will, wherever possible be contingent on the success of any tax recovery for shareholders and free of cost to the company.
4. Where withholding tax is newly addressed, the board will ensure they and shareholders are made aware of any Statutes of Limitations that apply to their company's shareholders by reason of its country of incorporation and ensure that appropriate remedial measures are taken to make shareholders aware of any historical value recovery entitlement and provide access to solutions for its recovery.

Proxy Voting Policies

Many shareholders use proxy voting firms to vote their shareholdings at annual general meetings. Such proxy voting is enacted under policy guidelines issued from time to time by these firms. Below is are examples of Global Proxy Voting guidelines as they might be affected by residence/non residence issues.

Allocation of Income
Vote FOR approval of the allocation of income, unless:

- **the company has made no arrangements to facilitate the recovery of over-withheld taxes for shareholders who are not resident in the country of incorporation.**

Mergers and Acquisitions:
Vote FOR mergers and acquisitions, unless:

- **the impact on earnings for shareholders is unequal on the basis of the residency of the shareholder.**

Shareholder Proposals:
Vote AGAINST proposals that

- limit the company's business activities or capabilities, result in significant costs being incurred with little or no benefit **or where shareholder earnings would be impacted unequally based on the country of residence of the shareholder**

Conclusion

Over $200 billion of tax is withheld each year by foreign governments on cross border investment income. Compounded by Statutes of Limitations, the extant over-withheld tax in the possession of governments rather than those to whom it belongs, is likely to be well over $600 billion at any one point.

Whilst intermediaries have a purely commercial interest in whether a shareholder's return on investment is maximised, the company and shareholder directly have most to gain, and lose. It's their money.

It's likely that in future, company boards of directors will come under increasing market-led pressure from more educated and aware non-resident institutional shareholders, to adopt corporate governance policies that more actively support their investment strategies and do not adversely impact them in comparison to their domestic counterparts.

Given the potential for a 35% difference in return between investing domestically and cross border, the absence of such corporate governance policies has the capacity to significantly affect international investment and portfolio planning. Corporate reputation, which is the public face of governance principles, is increasingly important in many ways and failure to address it could easily make or break such reputations and with them shareholder value.

Its also likely that firms interested in the management of corporate governance including proxy voting companies will include global policy guidelines with respect to withholding tax, that protect the interests of non resident shareholder groups. To that extent, large companies may be forced to adopt active strategies in advance rather than be forced to do so by shareholders at an annual general meeting.

While in the near future this is likely to be market led, in the longer term governments may take a more active interest and in addition to Double Tax Agreements that merely define entitlements, add regulatory requirements to ensure that between companies, intermediaries and shareholders, someone is properly tasked with the responsibility to make it happen.

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