TAXTEC

Lost Gains

Estimating unreclaimed withholding tax on foreign securities.

A Research Note from TaxTec, 2024

- **Securities income trends**
- **Are gains being fully realised?**
- **Issues for asset owners, managers and custodians**
- **How much WHT is being left on the table?**
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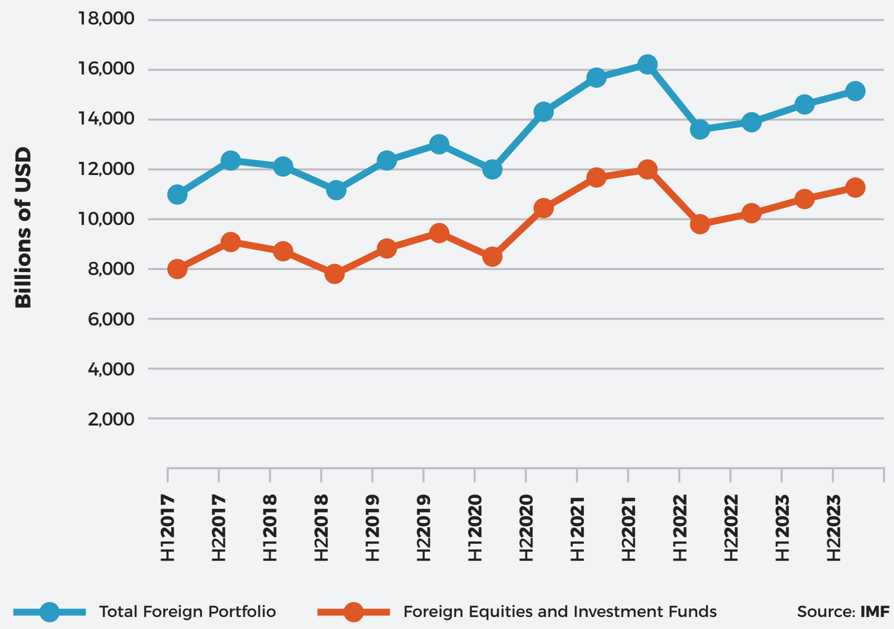
Securities income trends

Equity dividends have remained healthy and consistent since the Millennium, in contrast to other asset classes. For instance, payouts for the MSCI Europe have once again reached record levels, according to calculations by Allianz Global Investors,[1] and the dividend yield is following a positive trend too.

More recently, this has also been accompanied by rising bond yields, both sovereign or corporate. Analysis shows bond yields shooting up from 2022 onwards, in some cases overtaking dividend yields in various geographies including the Americas and South-East Asia.[2]

All this adds up to a leap in income rates from all securities — fixed income and equities alike. Additionally, the appetite for foreign investment has grown. Data from the International Monetary Fund reveals income from foreign stocks and bonds steadily growing over the last five years.

Example: **United States –** Foreign porfolio holdings



Source: **IMF**

Are gains being fully realised?

So far so good for investors. But do asset owners — pension funds, insurance companies, sovereign funds, hedge funds, high-net-worth individuals — enjoy the fullness of those dividends or interest payments?

Research from Taxtec would suggest not.

When foreign dividends or bond interest payments are made, the tax regime in question retains a certain level of withholding tax. Where that jurisdiction has a double taxation treaty with the investor's domicile, a proportion of that withholding tax is reclaimable.

The reclamation process is, however, bureaucratic and complex. Many studies have remarked on the convoluted process for reclaiming withholding tax.[3] The result is that not all reclaims are processed, with investors ending up losing a percentage of their rightful income.

Issues for asset owners, managers and custodians

While reclamation rates have improved over the last decade, TaxTec research shows that marginally over one fifth (by value) of eligible reclaims are still not processed.

This is an important issue for asset owners, fund managers and custodians for a number of reasons.

- First, investors are not receiving a proportion of the investment performance that is rightfully theirs. Fund beneficiaries (e.g. pensioners and investors) are therefore also losing out.
- Asset owners and fund managers have a fiduciary duty to return the full performance of investments to investors; meaning that failure to do so could raise regulatory issues of professional standards and regulation.
- The current investor trend towards green investments often comes with an income trade-off; investors agree to investing for a slightly lower return, therefore making the issue of maximizing those returns even more critical.

How much WHT is being left on the table?

Automated services to process eligible withholding tax reclaims are now widely available. Leading custodians are engaging with such services to provide an enhanced service to asset owners and managers. Nevertheless, a performance gap still exists.

TaxTec estimates that over $16 billion in unreclaimed withholding tax on foreign securities is still being ‘left on the table’.

To illustrate the scale of revenues lost to investors, TaxTec has deployed its data expertise to model the most up-to-date estimated figures for the world’s principal foreign equity markets. The model is based on trusted official data on foreign portfolio investment.[5]

This accompanying table on the following page presents the estimated returns due to investors in foreign securities that are still being ‘left on the table’ through failure to process withholding tax reclaims that are recoverable.

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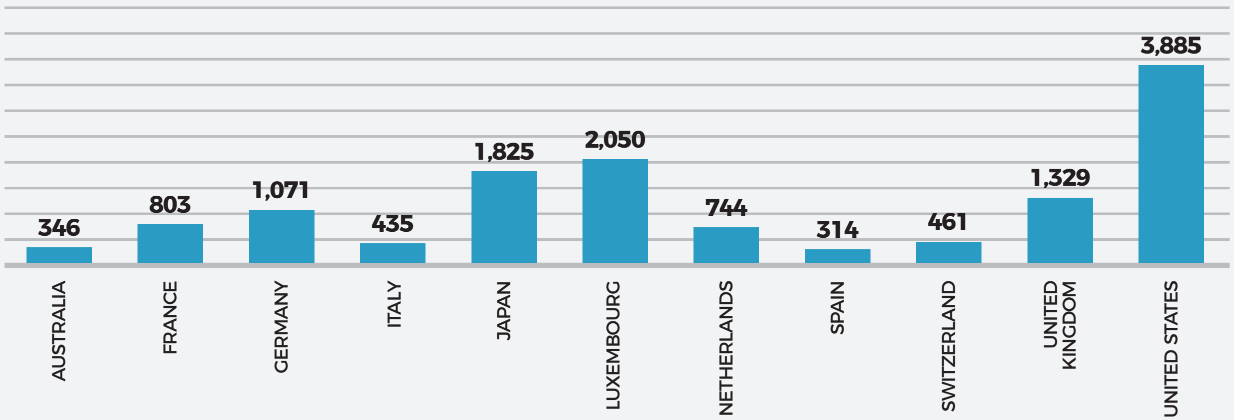
Unreclaimed withholding tax on foreign securities
TaxTec estimates 2024 (USD million)



METHODOLOGY

TaxTec combined its own proprietary data and market insights on actual reclamation rates with the most recent official data sources on foreign securities portfolios, as well as current data on share dividends and bond yields. The result is a series of retrospective estimates of the financial volumes represented by unreclaimed withholding tax for a number of countries' investor communities, as well as a global estimate. TaxTec will be renewing these estimates on an annual basis.

Summary of Key Takeaways

- Across the world – in all jurisdictions with taxation treaties – USD 16.4bn of investors' annual returns due from foreign stocks and bonds was lost because withholding tax on dividends and interest income is not being fully reclaimed.
- Reclamation rates on withholding tax have seen a continued marginal improvement over the last decade, thanks to automated specialist reclamation services, but there is more work to do to close the unreclaimed gap.
- The rising value of portfolio investments in foreign securities strongly suggests that this lack of tax reclamation needs urgent attention from institutional investors and their service providers.
- Of the individual countries studied, US investors are the biggest annual loser from unreclaimed withholding tax on foreign securities, followed by Luxembourg, Japan, the United Kingdom and Germany.
- Investors are becoming increasingly rigorous in their scrutiny of investments, putting pressure on asset owners, fund managers (and their agents) to provide greater transparency on tax reclaim performance.
- Tax recovery rates, rules and deadlines vary widely around the globe, making the reclaim process highly complex. However, highly automated technology solutions are available to take the cost and complexity out of the reclamation process.
- A handful of pioneering custodians have adopted these automated reclaim solutions to provide enhanced service levels to clients, but more widespread adoption is required to fully realise asset owners' lost gains.

Footnotes

1. https://www.allianzgi.com/en/press-centre/media/press-releases/20240116-dividend-payouts-in-europe-to-rise-again-in-2024-eur-433-billion-expected
2. ibid
3. See, for instance: https://discovery.researcher.life/article/maximizing-foreign-direct-investment-returns-unravelling-the-complexities-and-overcoming-challenges-in-dividend-withholding-tax-reclaim-processe/0017658494963b9b97bca051bc4a7930; https://publications.aaahq.org/accounting-review/article-abstract/98/2/299/399/Withholding-Taxes-Compliance-Cost-and-Foreign
4. Developed in collaboration with analyst MindMetre Research – https://www.mindmetreresearch.com/, and established for over 15 years
5. Sources and reference points include: TaxTec proprietary data; Global Stock Exchanges; The International Monetary Fund; The OECD; The Bond Market Association; The Federal Reserve; The European Central Bank; The Investment Management Association; The World Bank; Moody’s; Bloomberg; Standard and Poors; MSCI Indices; World Federation of Exchanges; Financial Times