Are rightful returns on securities being left to languish?

Stephen Everard, CEO of TaxTec, considers how technology can help improve the efficiency of withholding tax reclamation on foreign securities and drive portfolio returns

As iconic Canadian investment personality Kevin O'Leary said: "Never invest in a security or a stock that doesn't pay a dividend or interest."

That may be a surprising comment in markets that have moved inexorably upwards for the last 15 years (give or take a few notable wobbles such as Covid-19).

His advice is easy to dismiss as old school. Hold hard though. We have known major market corrections. And a range of studies underline the ongoing significance of dividends in the analysis of total returns.

One analyst tells us that over the last two decades, dividends have been responsible for around 25 per cent of the average monthly total return clocked up by the MSCI World index, at the same time as contributing practically no risk.

It does not take a genius to recognise that if dividend earnings are re-invested in equities, then they morph into compound capital and accelerate share value growth.

Investor types

Of course, different types of investors have different drivers and motivations. The pure accumulation of savings, prior to eventual drawdown, can focus purely on total returns from whatever source — earnings distribution or capital increment.

There is no need to be concerned about income. But if we look at a pension fund, the art of good and responsible fund management is to balance capital growth while also meeting the liquidity needs for paying retired beneficiaries.

Other studies also track a correlation between dividends and corporate financial health.

Analysts note that over the long term, dividend growers and initiators have generated higher returns with less risk, measured by standard deviation, than companies that maintained their dividends, paid no dividend and reduced or eliminated their dividends.

The conclusion has to be that dividends (and bond coupon income) form an important part of total returns, and that every effort should be made to maximise them, whether from an asset and investment management point of view, or from an investment services perspective.

Foreign securities

Furthermore, the popularity of foreign stocks is also attracting increasing financial volumes. Data from the International Monetary Fund (IMF) reveals income from foreign stocks and bonds steadily growing over the last ten years.

Further analysis of this IMF data shows how foreign investment portfolio values have changed over a 10-year period. The totality of cross-border securities investment has increased by 58 per cent over the period. If we apply this to one country — the United Kingdom — we see that total assets under management in UK institutions increased by just over a third in the last decade; by comparison, the UK's foreign equity investments expanded by over half.

This is where attention paid to tax matters becomes crucial.

UK Investors

Portfolio value in foreign equities 2013-2023 ($ million)

Tax withheld

Share dividends (and bond coupon) paid on investments held in a foreign jurisdiction are subject to withholding tax. No surprises there.

But the percentages involved can be significant. Especially if the reclaimable proportion of this withholding tax is not efficiently reclaimed (a proportion is not reclaimed — of which, more later).

To illustrate this issue, a few examples are revealing. The statutory withholding rate in most European countries is between 20 and 30 per cent.

A few are lower, but Switzerland is higher at 35 per cent. Of that percentage withheld, 10-15 percentage points can be reclaimed.

Again, in some double taxation treaties the reclaim rate is lower, but in others, all withholding tax can be reclaimed. The matrix of treaties is complex and varied, but the general point is that funds who do not reclaim withholding tax are depriving investors of a significant part of their rightful returns. In what other circumstance would it be acceptable to investors to throw away 15 per cent or more of their investment income?

The reality is that about one-fifth of all reclaimable withholding tax on foreign dividends is not recouped for investors. That is clearly an issue not just around the maths of total returns, but also an ethical point around the fiduciary duty of asset managers and asset service providers to deliver maximum possible returns to investors.

Unreclaimed volumes

So, how much does the unreclaimed portion represent?

Every year, TaxTec has compiled an analysis of the unreclaimed withholding tax gap, an analysis our founders have been carrying out for over 15 years.

Our latest study provides the most up-to-date global estimate as US$16.4 billion, with US cross-border investors missing out on over US$3.8 billion in rightful returns. UK Investors are leaving US$1.3 billion in unreclaimed withholding tax on the table.

There is no doubt that the reclamation process is complex and bureaucratic. Historically, investment administrators have sometimes concluded it to be uneconomic, costing more to do than the sums recovered.

Also, capital gains on stocks have prospered over the last two decades of a (mainly) bull run, it is all too easy to classify the benefits of reclaimed returns as less significant. Yet, recouped dividends make an important contribution either to current liquidity needs and/or to overall fund growth that itself may be re-invested to capture more capital growth.

And, as noted at the beginning of this brief article, long-term returns from equities investments are focused on dividends as much as capital gains.

With the assistance of modern technology — often AI-driven — there really is no excuse nowadays for this unreclaimed withholding tax to languish unrecovered.

Today's technology

As a preliminary, it is worth looking at systemic benefits of technology-enabled withholding tax reclaim processes. For instance, in the US, foreign companies are often listed in the form of an American Depositary Receipt.

The issuer of the security elects a depository (depo) bank to manage their alternative dispute resolution (ADR), including tax reclaims (actually administered by a tax service agent). Clearly it would be advantageous for the depo bank to easily see how the reclaim process is progressing across the period until final notification. Digital technology is now allowing that progress to be visible, both in value and in volume terms, as it happens.

This means the depo bank can manage its internal workflows and cashflows much better.

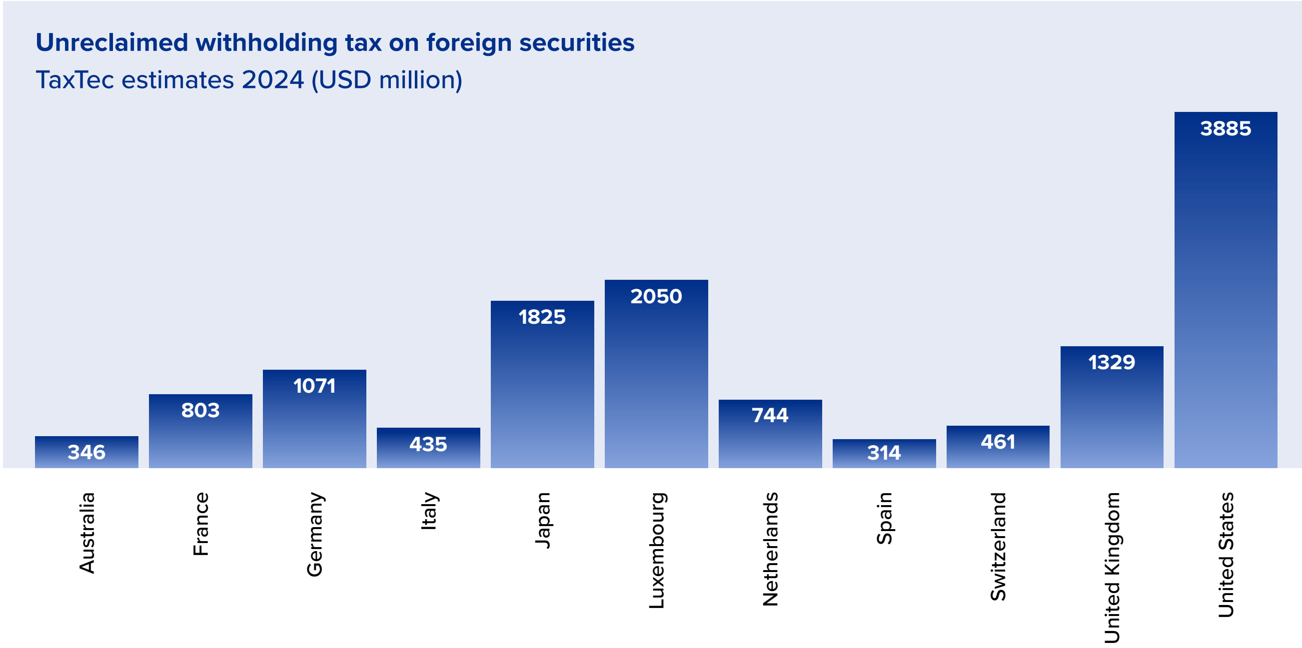
Turning to custodian banks (who manage reclaims for a portfolio, fund, or asset manager) these same digital capabilities make for a much more efficient and cost-effective service provision to its claimant clients.

First, the claimant sends the custodian data for its proposed reclaims. These can now be automatically and instantly validated — as to whether the data is correct and complete, whether a bona fide claim can be made, whether it sits within or outside any statute of limitations, and so on.

This capability is a huge bonus to both custodian and claimant. Considerable manual effort (and therefore cost) is eliminated and processes are greatly accelerated.

Second, the value and volume of reclaims can be viewed in real-time by the custodian, regarding their progress through the key stages of a reclaim — calculation/validation, documentation, authorisation, submission, and decision (payment, refusal, part payment, request for more information). This enables the custodian to provide accurate, more usable and more timely information to claimants.

Third, and most importantly, analysis can reveal where bottlenecks are occurring, allowing the custodian to determine their cause and whether any remedial action can be taken to speed up the reclaim process. A good example might be where preliminary documents are being held up at the beneficiary level. In this instance, the claimant and custodian might give power of attorney to the tax service provider to avoid this delay.



Similarly, delays at the tax authority end can help trigger investigations about internal resources and procedures to fix the issue. Equally, delays at the claimant end can help trigger investigations about internal resources and procedures to fix the issue.

Finally, by receiving this comprehensive and up-to-date progress information from the custodian, the claimant is able to manage its cash flows and portfolio strategies better than before.

Conclusions

In short, the efficient reclamation of withholding tax on foreign securities can make a significant difference to portfolio returns and tax efficiency.

Modern technology is improving the processing of reclaims and — inevitably — reducing costs. Considerable sums are at stake, with billions lying unreclaimed. Investors should be receiving their rightful returns, including tax reclaims where eligible. Indeed, for pension fund managers and trustees, and for their asset service providers, this is their fiduciary duty. The sums being left on the table should be delivered to rightful recipients, through the power of today's technological capabilities. ■

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