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WITHHOLDING TAX PROCESSES

**Identifying the Key Challenges and Potential Solutions to
Withholding Tax Relief and Recovery Processes**

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ISSA - Shaping the future of Securities Services.

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1. Introduction

There continue to be many frustrations in managing global withholding tax (WHT) relief and recovery processes. As a result, the ISSA Asset Servicing Working Group (WG) created a subgroup - entitled the WHT Processes subgroup (WHT WG) - specifically to focus on these issues.

This paper is the outcome of the WG's review of current WHT processes. After identifying the key challenges faced by Securities Services providers when handling WHT processes, and the impact of these challenges on the various parties, the WG then focussed on the potential solutions and recommendations for change.

The paper should be read by all parties involved in the WHT process and the recommendations should be followed to effect meaningful change in those markets where the challenges outlined exist. Regulators and tax authorities are recognizing that change is necessary and that increased cross-border collaboration is required for WHT processes to function successfully. These changes offer benefits not only to the Securities Services industry, but also the broader economy, providing for greater investment opportunities and cheaper financial funding for capital markets.

2. Challenges

Based on the collective experience of the WHT WG participants, below are documented observations on the current processes, as well as specific challenges, faced when undertaking the relief at source and tax reclaim processes.

Whilst these challenges have a profound impact on the whole Securities Services industry, they also impact international investors who may be 'tax disadvantaged'.

2.1 Documentation Challenges

By far the biggest ongoing issue found by the WHT WG is that of documentation. Multiple challenges were highlighted with documentation requirements, which are summarized as follows:

2.1.1 Hard-Copy Documentation

Hard-copy documentation is still required in many markets (either due to regulation or market practice), with the associated challenges provided:

- **Manual Paper-Based Documents:** The requirement in many markets is still very manual, heavily paper-based where documents need to be in original format and often signed in wet ink.
- **Shipping and Storage of Documents:** Documents must be shipped around the world to various parties which increases costs, creates time delays, storage issues and archiving challenges, not only for the investor but also for the tax authorities.
- **Limited Acceptance of Electronic Formats:** The use of electronic formats for supporting documents has not yet become widely accepted.

2.1.2 Inconsistent and Excessive Documentation

Every market has different documentation requirements, as highlighted below:

- **Translation, Notarization and/or Apostille Requirements:** Some markets require documents to be translated, as well as notarized or apostilled, which creates administrative challenges for the relevant stakeholders.
- **Transactional Data Requirements:** Various local markets also require transactional data for a specified period before and after the dividend event. This transactional data is often required in a very specific format that is different in each market, reflecting specified information fields that are of interest to the tax authorities. Given that financial intermediary systems differ in their level of sophistication, it is often difficult to impossible to provide these reports in a format that meets all of the requirements of the tax administrations.
- **Need for Multiple Documents:** Some countries require multiple documents in order to substantiate that tax was withheld on a specified income event. For example, some tax authorities in the country of investment will be satisfied with a dividend voucher/certificate from the final intermediary in the chain, while other tax authorities will require a payment confirmation from each different party in the payment chain. In addition to certificates of withholding provided by intermediaries, some tax authorities may go even further and request for example bank statements and SWIFT messages to substantiate the tax withheld. These proofs of tax withholding or dividend

payment are sometimes requested in formats that are substantially different from those produced by custodial systems, creating additional (manual) work and (email) interaction, increasing cost and risk.

- **Per-Payment Certification Requirement:** There are certain countries that require per-payment certification¹, which makes it more difficult for investors to obtain WHT relief at source. In some cases, these burdensome documentation requirements can drive non-resident taxpayers to forego their right to apply for the tax treaty benefits that they are entitled to or force them to seek costly tax advice, thereby leading to additional costs.
- **Validity of Documentation:** The validity period of supporting documents varies across markets; some must be renewed annually (e.g. Japan) and others can be valid for up to 10 years (e.g. Italy).

2.1.3 Proof of Tax Residency

Another issue highlighted is the difficulty in dealing with local tax authorities, around their proof of tax residency requirements and language barriers:

- **Use of Certificate of Tax Residence (COTR):** Most WHT relief and reclaim procedures require a COTR, that is issued by the tax administration of the taxpayer's country of residence, as proof of entitlement to treaty benefits. This residency confirmation can either take the form of a certification (stamp) on a specific treaty relief form as prescribed by the source country or a separate certificate issued by the residence tax authority. Most markets do not accept alternative forms of proof of tax residency and rely only on the traditional paper based COTRs. To exacerbate the problem even further, these COTRs have to be issued in the tax year in which the relevant income was received (i.e. a new tax COTR is required per year for which withholding tax relief is sought).
- **Additional Required Information:** In addition to the COTR, as evidence of treaty eligibility, some countries also release additional statements which they require the residency country to stamp as proof of entitlement to relief. This is prevalent when it comes to certain domestic law exemptions which collective investment schemes may be entitled to. Such statements seek to confirm additional elements regarding the taxpayer, e.g. that they are not considered fiscally tax-transparent². Where the country of source refuses to stamp these forms as a matter of policy (which is often the case), the taxpayer has to seek alternative documents to prove eligibility, which in turn is frequently not accepted by the tax administration.
- **Need for Original COTRs:** Some tax authorities only issue electronic COTRs. However, in many jurisdictions tax administrations require original COTRs which creates a mismatch between required documents versus those which can be provided.
- **Language Barriers:** There are frequently language barriers between the parties involved, where documentation has to be completed in the language of the country, but no translation is available and the terminology is difficult to follow.

¹ Per-Payment Certification – supporting documents required per income event as opposed to per calendar year

² Tax-transparent – these investment vehicles are viewed as look through entities and entitlement to withholding tax relief is determined at the level of the ultimate beneficial owner as opposed to the investment vehicle itself

2.1.4 Regulatory Impact on Documentation

There is some concern in the Securities Services industry that documentation and disclosure requirements may become more onerous in the future due to anticipated changes in Organization for Economic Cooperation and Development (OECD) regulation. These include:

- **BEPS Multilateral Instrument:** The adoption of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS Multilateral Instrument or MLI). This could result in a reinforcement of activities of local tax authorities to prevent abuse of Double Tax Treaty (DTT) provisions by investors. The MLI convention may also create additional workload and increased operational risk for custodians acting as tax withholding agents, as they may be obliged - by their respective regulations - not only to make sure that a cross-border investor, applying for a reduced DTT tax rate, is officially registered as a tax resident in a particular country, but also satisfies additional criteria introduced by the MLI to prevent the tax evasion. To fulfil these functions in a diligent and prudent way, tax agents may have to adopt a more conservative approach when reviewing tax documents, to mitigate their own risks and to protect the investors against potential regulatory breaches and penalties.
- **TRACE:** Further concerns exist around the adoption of the OECD's Treaty Relief and Compliance Enhancement (TRACE) model, where a lack of consistency in the interpretation of the treaty and their implementation could create further barriers in this space. Finland is the first country to implement TRACE, a system whereby Authorized Intermediaries become responsible for withholding the correct amount of tax on dividends. As of 01 January 2021, relief at source and other treaty benefits can only be granted by authorized intermediaries.

2.2 Procedural Challenges

Whilst documentation is raised as the biggest issue, procedural and process challenges are also considered significant. The key areas where procedures are an issue are outlined below:

2.2.1 Inconsistent Procedures

There are inconsistent procedures and approaches across different markets. These differences include:

- **The Type of Tax Relief Options Available:** For some markets you could apply for tax relief at source but for other markets the only possibility to get tax relief is via a standard refund. (For example, Denmark and Switzerland are reclaim only markets, whilst in Italy both relief at source and long form reclaims can be used – with a preference for relief at source.)
- **The Type of Tax Relief Available per Investor:** In some markets only a certain type of investor (e.g. funds) can benefit from tax relief at source, while others are not able to.
- **Dividend Entitlement:** It is often difficult to know who is entitled to the dividend (e.g. trade date versus record date principle, different rules on collateral management, market claims or stock lending activities).

- **Tax Reporting, both in Formats, Communication Channels and Data required:** These differences need to be stored and monitored in case of changes, so that the intermediaries can inform their clients (which are the investors). Investors need to react to these changes to ensure they comply with the requirements to continue to benefit from tax relief. This process needs to be in place per market and the quality is heavily dependent on the knowledge of the market. This is costly due to a high level of expertise required and is time consuming for both intermediaries and investors.
- **Statute of Limitation:** Statutes of limitation are not applied consistently across jurisdictions with different timelines and approaches being adopted by different markets.
- **Within Jurisdiction Requirements:** Requirements are not consistently applied within jurisdictions where different case handlers assess similar situations differently or different parties in the custody chain require different documents for reclaim or relief processes.
- **Investor Eligibility:** There is frequently a lack of clarity with regard to which investor types are eligible for relief. There is an inconsistency in this area across territories, which makes it increasingly difficult for the investor itself - as well as parties within the income payment chain - to make concrete assessments on eligibility.
- **Lack of Reporting:** Often, once the documentation has been submitted, there is no transparency or reporting available from the local tax authorities for the custodian, and investor, to know the progress and status of a claim.

2.2.2 Highly Manual Processes

Although it was hoped that the COVID-19 pandemic would be a catalyst in the move towards the acceptance and use of electronic documents, this has not yet happened and processes continue to be highly manual. Examples include:

- **Lack of Alignment of Digital Initiatives:** The digital initiatives of tax authorities in various countries have not been aligned which has resulted in WHT relief and recovery stakeholders having to cater to many different systems, processes and procedures.
- **Partial Automation:** Many of the tax authority portals which have been implemented have only partially automated the process.
- **Manual Input of Single Events:** Many portals require that claims related to WHT on each income tax event be manually input as opposed to allowing bulk upload/insertion of events.
- **Investor Action Required:** Some portals require end investor action, adding another layer of complexity.

3. Impact of Challenges

Given the multiple challenges faced when dealing with WHT, the WG felt it was also important to highlight the key impacts these challenges have on the various parties involved in WHT processes.

3.1 Investors

- Inconsistent and complex procedures are leading to investors not wishing to invest in certain markets. This is particularly the case for non-domestic investors.
- Investors face a high cost (both in terms of resources and opportunity costs) to file withholding tax reclaims, either independently or through a service provider.
- The effort to obtain supporting documentation for relief, as well as cost and the need to renew certain documents (such as COTRs) annually, can prohibit investors from pursuing their rights to relief.
- Reduced returns are suffered on investments when withholding tax cannot be recovered.
- Investors have an opportunity loss due to the excessive time to recover reclaims in certain markets.
- Small investors often lose out as the cost of claiming is too high compared with the actual value of the investment.

3.2 Custodians and Financial Intermediaries

- There is a high cost required to support WHT processes due to the constant changes to forms and requirements.
- The custodians and financial intermediaries face inherent risks associated with claiming relief where investors may not be entitled to a claim or miss the opportunity to claim retrospectively.
- There are often delays associated with audits and late claw backs from tax authorities which impact the custodians and financial intermediaries in multiple ways.

3.3 Local Markets

- Local markets may suffer reduced foreign investment due to cumbersome and costly WHT processes.
- There is a higher capital market cost for local companies.

3.4 Tax Authorities

- High costs are incurred in managing large volumes of retrospective reclaims and keeping claimants informed on the status of their reclaims, which results in further delays when assessing and paying claims.
- There is a risk of fraud, as well as the incorrect payment of claims, which are not eligible for recovery.
- The storage and management of a huge amount of paper is onerous, with the associated risk of claims being misplaced.

4. Proposed Solutions

Whilst there continue to be many challenges to processing WHT, the WG participants also see opportunities to make the processes better. The WG has outlined, below, changes which could improve WHT processes - improvements which will be key in simplifying cross-border investment, simplifying the operations of the various tax authorities and minimizing WHT leakage for global investors. The WG participants have proposed some areas of improvement for existing processes. They have also, though, outlined three industry-wide changes which could fundamentally improve the way that the WHT relief and reclaim processes would work.

In an ideal world, any industry-wide changes would be implemented immediately. However, it is recognized that this type of change takes time. Therefore, although there will be effort and cost involved in improving the existing processes, the WG feel the changes are still worthwhile given the length of time to development and adoption of entirely new processes.

4.1 Improving Existing Processes

The WG believes that there are a number of incremental changes, and tactical solutions, available that could improve the existing processes. These include changes in the following areas:

4.1.1 Acceptance of Standard COTRs issued by Tax Authorities

The acceptance of a single format and wording for COTRs across all markets, as opposed to requirements for customized COTRs and stamped documentation, would remove the inconsistencies that currently exist.

4.1.2 Acceptance of Scanned Copies of Documentation

Accepting electronic signatures on PDF documents, as an alternative to original, wet ink signature documents would simplify and speed up the signature process.

4.1.3 Simplification of Documentation across Different Markets

Consistent requirements across markets in terms of validity period of documents, format of documents, document contents and required support for relief and reclaims would make the process much more efficient.

4.1.4 Concessions for Smaller Investments

Simplification - or removal - of certain documentation requirements by tax authorities for small investments would assist the reclaim process for smaller investors.

4.1.5 Improved Communication with Tax Authorities

Communication to and from tax authorities could be improved through:

- Financial intermediaries and other providers being able to submit standard refund claims to source tax authorities in bulk.
- Tax authorities and affected parties discussing improvements to address many of the current inefficiencies in the process.
- Improved reporting from the tax authorities so that it is possible to track the status of the tax reclaim (similar in approach to Denmark and Switzerland).
- Standardisation of the withholding agent reporting to the source tax authorities

4.1.6 Improved Communication between Financial Intermediaries / Withholding Agents and other Providers

There is a need for a consistent flow of information between parties to ensure standardized formats and ease of communication. The WG recommends a standardized straight-through processing (STP) format of communication up and down payment chains for the purposes of WHT related matters (e.g. using SWIFT, APIs, etc).

4.1.7 Relief at Source as the Standard with Tax Reclaims as the Exception

The goal across all investment jurisdictions should be to minimize the need for retrospective reclaims. This is only possible if all countries adopt a form of RAS where relief can be obtained in a reasonable time frame with supporting documents which are readily available. The current impediment for many markets seems to be the risk of fraud, therefore this would need to be addressed as part of the adoption process.

4.2 Introduction of Industry-Wide Changes

The adoption of the above changes to existing processes would already resolve a number of the key challenges that are faced by financial intermediaries on an ongoing basis as well as improve the investor experience. However, the WG participants believe that - longer-term - a complete overhaul of the WHT process would provide real benefits. The participants propose three major changes that could transform the WHT life cycle.

4.2.1 Approach for Sharing Investor Eligibility to Tax Relief

The introduction of an approach that would allow direct information to be shared between the two different tax authorities involved in the WHT process would fundamentally change the way that WHT is processed. By enabling a tax authority to directly access the COTR (where required) and investor (i.e. ultimate beneficial owner) information, the tax authorities would be able to quickly validate the eligibility of an investor to tax relief. There should be a great emphasis on including information sharing in Double Taxation Treaty provisions. The introduction of a Unique Transaction Identifier (UTI) for the dividend transaction would assist in identification of the information by all parties. (Examples of where a shared approach has been introduced would be the Alert SSI utility and the ISSA Due Diligence Questionnaire.)

4.2.2 Introduction of a WHT Central Repository

A further proposal discussed by the participants was the development of a central depository for all WHT information. As with other central repositories, the aim would be that all key parties in the chain (i.e. financial intermediaries, tax authorities, service providers and issuers) would have access to, and relevant responsibility for providing, all information to one central place. This would have even more benefit if it could include, at some juncture, a data dictionary of standard terms.

4.2.3 Adoption of a Universally Recognized Tax Identification Standard

The introduction of a tax identification standard that could be assigned to each investor, could revolutionize WHT processes. If adopted universally, the tax identification would enable tax authorities and financial intermediaries to immediately recognize what level of relief an investor is entitled and remove the ongoing issues that arise.

5. Conclusion

It is evident that WHT processes around the world continue to be plagued by inefficiencies and inconsistencies. Change is required to promote ongoing cross-border investment and reduce unnecessary WHT exposure for global investors. Without significant commitment to improving the WHT processes and procedures, custodians, CSDs, tax authorities and – ultimately - investors will continue to suffer from the lack of harmonization in this field.

The WG participants believe that it is vital that regulators, tax authorities, industry participants and the global investment community do come together to find creative solutions in order to drive change. A basis for this dialogue is outlined within this paper but these, while ISSA believes them to be practical, are not the only possible solutions. This change may take the form of industry wide directives, changes to legislation as well as procedural amendments - but change is the only way forward.

That is why the WHT WG was delighted to hear the recent announcement by the EU Commission, that it has started a consultative initiative with the public to develop a new EU system to avoid double taxation. This demonstrates recognition of the challenges the industry is currently facing and a willingness to effect meaningful change in this area³.

However, the EU - whilst a large market - is not the only geography where the problems arise. All markets across the globe should strive to optimize WHT processes for the benefit of economic growth and access to the cheap sources of capital. The WG participants believe the suggested solutions above should be the minimum standard across the globe.

³ https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13031-Retenués-a-la-source-nouveau-système-de-l%E2%80%99UE-visant-a-éviter-la-double-imposition/public-consultation_en

6. Institutions Represented in the WHT Working Group

Acupay System

Broadridge Financial Solutions

Deutsche Börse Group / Clearstream

Euroclear

GlobeTax Services

HSBC Holdings

ISSA

NSDL Group

S&P Global / IHS Markit

Standard Chartered Bank

SWIFT

Tata Consultancy Services

The Depository Trust & Clearing Corporation DTCC

UniCredit

WTax UK