Fundsmith

Fundsmith Investors' Topics

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A look at withholding taxes

A recent query from a client about Fundsmith's position on withholding taxes highlighted some interesting aspects which we felt may be useful for all investors. We note that the email the investor sent to us had the subject title "Withholding Tax – Another Hidden Charge?" and made mention of Terry's repeated concerns about the true cost of management. This article attempts to highlight some differences between directly held shares, where an investor has a high degree of control over the impact of withholding tax, and funds, where the investor has little control over its impact.

For those who may know little about withholding taxes, they are taxes that can be applied to income from overseas shares (held directly by an investor or through a fund). Furthermore, withholding taxes can apply even if capital is invested in a tax-free wrapper such as an individual savings account (Isa) or a self-invested personal pension (Sipp). Thus, even if you believe your returns are 'tax free', this may not actually be the case in practice.

Funds, pension funds and direct holders (via brokerage accounts) are all subject to different withholding tax calculations and methods for submitting reclaims. If you hold European dividend paying shares directly, it is a good idea to check with your broker what rates are now payable and how to submit claims for repayments/lower rates.

The Brexit effect

As the changes brought around by Brexit only came into force from 1st January 2021, many asset managers and brokerages may still be feeling their way into the new rules. An important point to note is that reliefs which were automatic on EU situ shares for funds whilst an EU member, no longer apply and instead reliefs will be determined by the UK's tax treaties with other nations. Using France as an example, the rate of withholding tax prior to 1st January 2021 for UK resident funds was 0%. The new statutory rate is 26.5%. By submitting a claim under the UK/France treaty a lower rate of 15% is obtainable. Discussions remain ongoing around the ability of funds (not individuals) to benefit from the lower rates available pre-Brexit (e.g. 0% in France) thanks to the 'equivalence rules' that sees the UK treated as a 'third country' entity. However, this may require a European Court of Justice (ECJ) ruling. If such a ruling is eventually forthcoming, funds will have superior withholding tax treatment than individually held EU situ shares.

Shares held directly through brokerage accounts

In an era when dividend payments are low, it may be easy to overlook this 'hidden' tax and its effects. Our investor used an example of a share they held through dealing (brokerage) account in a Swedish company called Investor AB. This share had a dividend yield of 2% and was subject to a withholding tax of 30%, i.e. the investor received 1.4% after tax. The share was sold and repurchased through a Sipp. Thanks to the Sipp manager submitting a claim for a lower treaty based withholding rate, once held through the Sipp, the withholding tax rate reduced to 5%. In other words, the investor received 1.9% after tax (keeping 0.5% more of the dividend) once held in the Sipp. The majority of Sipp managers and platforms do not submit claims on behalf of their investors so you should check the position if you hold foreign shares in this way.

Over the longer term, the potential 'loss' to the investor can grow significantly thanks to having a smaller sum (after tax) on which compounding can work its magic. And remember that you don't necessarily have to hold the same share for this loss of compounding to hurt – it's the fact that taxes reduce the amount you have available to grow that is the important factor when talking about compounding.

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The good news is that an investor holding shares through a brokerage account may be able to claim a lower withholding tax rate up front or claim a refund of withheld taxes. The bad news is that this is often far from easy to do. Different jurisdictions around the world have different withholding tax rates and different processes. As with Sipp managers, most of the large and well-known online brokerage firms will be of limited help in this area with the individual account holder responsible for any refund claims. The Investors Chronicle wrote an article about this topic in 2018 (found here) and it does a good job of highlighting the challenges an investor faces. Even though the article is almost 3 years old, the facts presented are broadly correct (unfortunately, the Dutch did not scrap withholding tax in 2020 though).

Overseas shares held via a fund

One of the potential benefits of investing in overseas shares via funds is that the fund manager (or administrator) may do all the hard work around withholding tax refunds for you. The important word here is may. Many investors believe that their fund manager does this type of administration as a matter of routine but this is unfortunately not so. Can you check a fund's position on withholding taxes? Yes, it should be possible and there are two ways we suggest you look at this.

First, you can simply ask the manager what their position is. The Fundsmith answer would be: "We do all claims for refunds and/or lower Treaty rates in-house. If we hold a position in the fund and we can claim a lower withholding rate, we will".

Our second suggestion involves looking at information found in the annual reports and accounts. These will detail the dividends received in a year, the withholding taxes that were paid and the amount where claims have been submitted for tax refunds.

If you simply divide the tax paid by the dividends received and multiply by 100 you get the effective withholding tax rate. The Fundsmith equity fund accounts show the following:

Overseas dividends	£244,289,584
Overseas tax	£23,496,643
Effective tax rate is	£23,496,643/£244,289,584 x 100 = 9.6%

The standard rate of withholding tax is 30% in the US, 26.5% in France and 27% in Denmark. The far lower effective tax rate of 9.6% shows the benefit of Fundsmith pursuing all possible avenues to reclaim withholding taxes.

You can use effective tax rates to compare funds holding overseas shares to an extent. If funds receiving dividends have similar allocations to certain countries, you could reasonably expect similar effective tax rates. If there is a difference that you believe warrants investigation, you are entitled to ask why. We stress though that global funds with very different country allocations may have vastly different tax rates so this is only useful if you are comparing similar funds.

At a fund level, you may see this amount as small and nothing to be concerned about compared to the individual stock example given earlier. And we would agree that there are more important aspects to focus on when choosing a fund, especially if the manager keeps this 'hidden charge' as low as possible, which we endeavour to do. But a few more basis points here and there soon add up. It's easy to focus solely on headline annual management charges and miss other ways value is being lost to the fund investor.

The takeaway is simply this. If you hold or plan to hold overseas equities, make sure you look at the possible effects of withholding taxes so that you can do everything possible to minimise their impact. If you want to hold overseas shares directly, you have the ability to decide what effort you want to put into reclaims and if one broker/platform offers more assistance here than another, knowing that is useful information. If you hold a fund, you cannot really influence the manager in this regard. However, if you are comparing two or more similar funds, looking at their policies with regards to withholding taxes may be another useful tactic. After all, if all else is broadly equal, you would likely favour the one that puts more effort into claiming back taxes, would you not?

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