Morgan Stanley

INTERNATIONAL WEALTH MANAGEMENT

Investments for International Clients

Investment decisions require taking into account investment factors, including but not limited to, beta, alpha, current interest rates, and economic cycle status. Moreover, the tax implication of the investments is a factor that has recently become an important consideration with regards to investment decisions.

Wealth and Estate Planning Strategists

Family Office Resources

THE DECISION TREE FOR INVESTMENTS

Before implementing a portfolio an investor must determine the level of risk he or she can sustain over time. This determination may lead to the appropriate asset allocation to help achieve his or her goals and objectives. Once the client's asset allocation—which may include equities, fixed income, and/or alternative investments—is determined, the portfolio can be constructed and implemented.

As tax systems have evolved across countries from simple territorial income taxation[1] to worldwide income taxation with complex anti-deferral provisions—where income tax is paid on income generated worldwide even if generated or accumulated under foreign entities or investment vehicles- investors need to consider the tax consequences of investments with more scrutiny.[2] These considerations should not be limited to tax rates. They should also consider the differences in filing and reporting requirements.

In today's global economy there are many investment vehicles and products that can be used to help an investor achieve his or her goals. Investors have many ways to achieve a diversified portfolio. Here are three ways:

- Constructing a portfolio of securities themselves, held in his or her name, with or without the advice of a brok;
- Hiring one or more investment advisors to construct and manage his or her portfolio of securities (which is usually known as Separate Managed Accounts (SMAs));
- Buying or investing in exchange traded funds (ETFs) or mutual funds. Both products are commingled or pooling vehicles that invest in diversified portfolios given a certain strategy or objective. The difference between one another from an investment perspective is that the ETFs invest in a more passive or index linked manner while mutual funds are more often actively managed

The strategies that are available have different taxation and fee levels, which when compared against each other could have substantial differences in after tax returns.

For purposes of this paper we will consider that the profits of the investment account are subject to income tax in the country of residency of the client.

Please note that these are not recommendations, that Morgan Stanley does not provide tax advice, and that certain products may not be available in certain jurisdictions

Comparison Between the Above and Described Portfolio Building Methods

POSSIBLE TAX TREATMENT OF THE STRATEGIES

In the first two cases, self-management of individual securities or SMAs, the portfolio would be comprised of bonds, stocks, derivatives and other financial investments. In both cases, all activity may have an immediate tax impact for the clients. Some countries impose different tax rates to interest, dividends or capital gains. Investors should understand the tax rates on interest, coupons and/or dividends received and the capital gains tax applicable each time a security is sold. One of the main differences between the two portfolios resides on the fact that in self-managed accounts the client may consider the tax implications of each individual security, while investment managers in SMAs are usually more accustomed to taking a tax neutral approach and may not vary his or her strategy based on the tax domicile of the client. A frequently used strategy by investors and managers is tax loss harvesting: the practice of selling a security that has experienced a loss to offset taxes on gains and in some cases other income.

Apart from the financial implications, the strategy employed in the portfolio may require the disclosure of each investment transaction in the client's tax return, creating an administrative burden not only for the calculation of the tax due but on the filing requirements. SMAs may have an active strategy that reflects a higher quantity of transactions to be disclosed.

In the case of implementing a portfolio using pooling vehicles, the investor purchases shares or participating units in one or more investment vehicles (ETFs or mutual funds, among others, and for purposes of this paper we will call them "Funds"). These pooled investments invest in a diversified portfolio following his or her specific strategy. Unlike US mutual funds that are required to make distributions of income and gains to his or her investors, offshore Funds may offer accumulating share classes that reinvest the income and gains without providing an income stream to the client. Due to the fact that the investor has no control of the Fund, depending on the tax laws of the country of residency of the client, a taxable event may be triggered only upon distributions from, or disposition of, the Fund. This allows the client to defer realization of income or gains on the underlying activity until the distribution or disposition. Other advantages may be that (i) capital losses and cost of leverage may be offset against income or capital gains at the Fund level, (ii) fluctuation of currencies related to the Fund's underlying investments would not make an impact until redemption and (iii) if there are no distributions or redemptions, the information to include in a tax return could be significantly reduced when compared with owning individual securities.

Another thing to consider is the tax paid or withheld abroad. When the assets are withheld in the name of the client, it may be possible to credit these amounts to offset the tax applicable in the country of residency of the client. In the case of taxes paid by or withheld to a Fund or foreign vehicle, the tax credit may not be considered, creating a second level of taxation on certain income.

COSTS ASSOCIATED WITH THE STRATEGIES

In the case of self-management of the investments, clients need to consider the transactional costs of the activity. If the client receives the advice of an investment advisor, a wrap up fee may be agreed to include the fee for the advice and for the transactions. When we compare ETFs with mutual funds, we usually see a lower overall cost in ETFs due to the more passive investment strategy. In the case of SMAs, they may have some costs advantages compared to mutual funds due to the fact that they do not have the costs to set up and maintain the legal vehicles, among other regulatory expenses (registration, public listings, etc.). Notwithstanding the foregoing, institutional share classes of mutual funds are competitive from a cost perspective as well.

TRANSPARENCY AND INFORMATION ABOUT INVESTMENTS

When the final investments are held in the clients' accounts, as we have described for self-management and SMAs, all the transactions and positions are disclosed in the account and the clients have access to them at any moment in time. They have full disclosure of the investment strategy. Regarding Funds, clients only see one position in his or her investment account. They do not have access to the underlying securities other than through the monthly or quarterly reports. These reports may describe only the largest holdings or activities and provide detailed aggregate data, but do not usually list all the investments and activities.

PORTABILITY OF INVESTMENTS

In addition to the distinctions above, there are other factors that may also be relevant to clients such as the portability of the investments if they desire to move the investment to other financial institution. Individual securities can usually be held in the custody of most broker dealers or financial institutions and may be transferred freely. With regards to SMAs, even though the securities may be transferred, the manager might be required to be an approved vendor of the new financial institution, meaning that assets may be transferred but the client may be required to replace the investment manager. Lastly, for the case of ETFs and mutual funds, financial institutions need to have an agreement with the issuer to be able to custody said investment. Therefore, the clients, in some cases, may be required to redeem or sell the position instead of transferring it out.

	Self-Managed Account	Separately Managed Accounts (SMAs)	ETF	Mutual Funds
COST	Transaction cost or wrap fee	Might be more efficient than mutual funds due to fewer regulatory expenses	Might be more efficient than mutual funds or SMAs due to passive investment strategies	Include active management and regulatory fees. Institutional classes are highly competitive.
TAX TREATMENT	Depends on each asset and transaction. Investments may be tailored to the tax status of the client	Depends on each asset and transaction. The manager may not take into consideration the tax status of the client	Accumulating share classes may be taxed upon sale of the ETF on the appreciation in value	Accumulating share classes may be taxed upon redemption of the mutual fund on the appreciation in value
TRANSPARENCY	Full disclosure of investments and activity	Full disclosure of investments and activity	Limited information on monthly or quarterly reports	Limited information on monthly or quarterly reports
PORTABILITY	Assets may be transferred freely	Assets may be transferred but may require the replacement of Investment manager	May be transferred to financial institutions that have an agreement with the issuer	

[1] The territorial system taxes income earned within a country's borders. It applies to all businesses that operate and income that is generated within a country's boundaries. Income generated outside of the country's border is not subject to taxes.

[2] As provided by FINRA Rule 2111, the "tax status, such as marginal tax rate" is one of the nine key data items relevant to determine the suitability of investments.

Important Disclosure

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Morgan Stanley has an extensive number or investment products, managers and strategies to allow a foreign client to implement his or her portfolio depending on his or her particular circumstances. The client shall involve its legal and tax advisors in the design and definition of his or her tailored investment strategy.

Investors should carefully consider the investment objectives, risks, charges and expenses of a mutual fund or exchange traded fund (ETF) before investing. The prospectus contains this and other information about the mutual fund or ETF. To obtain a prospectus, contact your Financial Advisor or visit the mutual fund or ETF company's website. Please read the prospectus carefully before investing.

NOT ALL PRODUCTS AND SERVICES ARE AVAILABLE IN ALL JURISDICTIONS

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