OffshoreRed

Five questions expats should ask before choosing an offshore custodian

There are a number of factors to consider when selecting an offshore custodian, as well as numerous custodians from which to choose. No one financial institution is a perfect fit for all expatriates. Chad Creveling, CFA and Peggy Creveling, CFA have put together a list of issues to consider.

When it comes to building an investment portfolio, one of the first decisions many expats need to make is selecting an appropriate global custodian. A custodian is a financial institution such as a brokerage, asset management company or bank which holds investment assets and buys and sells various global investment products. It may also provide various banking facilities, such as savings accounts, checking facilities, debit cards and other services.

There are a number of factors to consider when selecting an offshore custodian, as well as numerous custodians from which to choose. No one financial institution is a perfect fit for all expatriates. To help you narrow the choices and find the best custodian for your clients' unique circumstances, we've put together a list of the major issues to consider.

How strong is the regulatory supervision over the custodian?
All custodians claim to be "well-regulated," but it is not safe to assume that there will be the same safeguards as pertain in the client's home country. Different offshore jurisdictions offer varying levels of protection to the expatriate financial consumer, and in some cases there may be little recourse if something goes wrong. It is unfortunately true to say that there is a fair amount of outright fraud in the offshore world.

One should always contact the custodian's regulating authority. Ask the regulator if the prospective custodian is actually regulated by them. Find out if there have been any complaints filed against the custodian, the nature of those complaints, how they were resolved, as well as what procedures there are for redressing problems. Due diligence in this area can really pay off. Above all, be aware that it may turn out that a particular institution is not regulated anywhere. This may seem obvious but the advisor who sells a financial product held at a custodian in a particular jurisdiction may not be regulated by the same regulating authority as the custodian or may not be regulated at all. Both the advisor and the custodian that conducts the transaction and holds the investment asset need to be regulated. Some advisors misleadingly imply they are regulated, when in fact they mean the custodian is regulated. This matters, because if the advisor provides misleading or negligent advice, the custodian's regulator will be of no help in a dispute.

What happens to your assets if the offshore bank or broker goes bust?
This is another important question to be asked of the respective custodian. Generally, investment assets such as stocks and mutual funds held in an offshore brokerage account are juristic entities separate from the custodian. If the custodian goes bankrupt, investments should not be affected, although it may take time and effort to claim the assets. Remember, however, that while there is protection from bankruptcy of the custodian, investment loss is not covered.

Cash assets held at an offshore broker or bank account are liabilities of the custodian and it is important to find out how cash deposits are guaranteed, who guarantees them and up to what amount. Be wary of any non-U.S. custodian claiming to be protected by U.S. SIPC (Securities Investor Protection Corporation) brokerage insurance – such a custodian is likely to be a fraud.

A good tip is to resist the urge to focus on above-market deposit rates for a given currency—a bank may be offering unsustainably high rates because it's taking on too much risk in its lending practices. Some examples of this include the practices of some banks in Iceland and Ireland prior to the recent financial crisis.

What products does the custodian offer and what do they cost?
Look for custodians that offer a full range of global investment products including cash management products, mutual funds and exchange traded funds (ETFs). Compare costs to include custodian fees, transaction fees, mutual fund fees, transfer fees and others.

Many offshore custodians only offer a limited range of their own branded products marketed through an expensive direct sales force of IFAs. A discount broker may be a better solution, but would require the expat either to manage their own investments, or to work with an advisor who is truly independent. The savings compared to fee-laden actively managed mutual funds or investment-linked insurance schemes can be substantial.

How transparent and accessible will the account be?
Given the mobile life of the typical expat, at a minimum it should be possible to access an offshore account online, both to place trades and to check account balances. The custodian should also provide monthly account statements, at least on request. Complete, detailed information on purchases, distributions, and fees and commissions should be available either online, in statements or both. The custodian should also operate a customer call centre with hours suitable to the client's location and in their language should they have any problems or questions, or need to transfer funds.

It is also worth checking on the procedures, cost and time it takes to transfer funds from the offshore custodian to another bank account. This goes for redeeming funds as well. There should be no restrictions or lock-in periods and it should be possible to redeem funds within a few days at most.

It's important to be aware that direct transfers between banks and custodians in different countries may not always be possible. For example, custodians in some countries may not accept transfers from banks in countries that have not signed legislation to prevent money laundering or which are believed to have lax standards in this area.

How will the investments be taxed?

For many expats, avoiding home country taxes is one of the primary reasons for considering a global custodian. In choosing a global custodian, it is necessary to consider both the tax regime of the jurisdiction where the custodian is located and the client's country of residence. Advice should be sought on how capital gains, dividends and interest will be taxed by the potential custodian's jurisdiction (including withholding taxes), as well as by the client's country of residence, and potentially their home country (particularly if the client is an American, who will be subject to worldwide taxation). Consideration of the implications of inheritance or estate and gift tax rules in the various jurisdictions is vital.

*Length of Residen*cy

To deal with an increasingly global workforce, many countries now have different income tax rules for expats who are temporary residents for work purposes and for those who stay longer. Some offer a period of time (generally up to five years) where the offshore investment income of expats is not taxed, although a special trust may need to be set up for this purpose. Some countries may not tax the offshore income of foreign residents at all. It pays to understand the client's specific circumstances, as there are many permutations possible between the tax systems of their country of residence, their home country and the offshore jurisdiction.

For U.S. citizens

There's no law prohibiting U.S. citizens from holding assets at an offshore custodian. The United States taxes its citizens on global income, however, so there's generally no tax advantage for expat Americans holding their assets at offshore accounts.

In practice, the recent crackdown by the IRS on undeclared offshore accounts and the increased regulatory burden placed on offshore custodians to comply with the U.S. tax code has prompted many offshore financial institutions to shut their doors to American clients. In addition, the increased reporting requirements, punitive tax rates assessed on foreign domiciled assets and penalties for non-compliance generally preclude American expats from benefitting from the use of offshore custodians. For most, a U.S. custodian will provide greater product range, lower fees, tighter regulation, fewer reporting requirements and a lower tax burden.

It is a common mistake amongst many expats to focus on income tax considerations, but care is needed to ascertain the estate or inheritance taxes that may apply to. One should also be aware that U.S. assets (including U.S. stocks) owned in U.S. brokerage accounts – even if they're in offshore locations like Hong Kong – may be subject to U.S. estate tax rules for Non-Resident Aliens (NRAs). The tax calculation rules are complex, but the end result is that only up to $60,000 of U.S. assets can be shielded from U.S. estate tax. To receive higher deductions, a U.S. estate tax return declaring worldwide assets to the IRS would need to be filed. U.S. estate tax applied to foreigners is no joke; according to IRS data, in 2009, the estates of deceased NRAs ended up paying an aggregate of 23% net U.S. estate tax on total gross U.S.-held assets.

Chad Creveling, CFA and Peggy Creveling, CFA own Creveling & Creveling, a private wealth advisory firm specializing in helping expatriates living in Thailand and throughout Southeast Asia build and preserve their wealth. Through a unique, integrated consulting approach, Creveling & Creveling is dedicated to helping clients cut through the financial intricacies of expat life, make better decisions with their money, and take the steps necessary to provide a more secure future. For more information visit www.crevelingandcreveling.com.

June 2011, Volume 16 Number 5