



Offshore Hedge Funds: Do's and Don'ts

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The word “offshore” has a certain mystique to many. Offshore hedge funds are investment vehicles organized in offshore financial centers (“OFC”). OFCs are countries that cater to the establishment and administration of mutual and hedge funds (“funds”). Offshore funds offer securities primarily to non-U.S. investors and to U.S. tax-exempt investors (e.g., retirement plans, pension plans, universities, hospitals, etc.). U.S. money managers who have significant potential investors outside the United States and tax-exempt investors typically create offshore funds. In many OFCs, the low costs setting up a company along with a kind tax environment make them attractive to establishing funds.

The Do's and Don't of offshore funds are can be summed up as follows:

Do: Consider setting up an offshore fund if you manage money for either foreign and/or U.S. tax-exempt individuals and businesses.

Don't: Go offshore to avoid U.S. taxation. This is the wrong reason to consider an offshore fund.

What is "offshore?"

Investment fund managers typically create offshore funds in Caribbean OFCs, although a European offshore entity may be more appropriate if a significant number of European investors are involved. Funds legally domiciled in OFCs hold around half of the hedge fund assets reported by the TASS hedge fund data base, with the British Virgin Island and the Cayman Islands being the most popular location. It has been estimated that over half of the world's funds are incorporated in the British Virgin Islands However; management of funds is often conducted in or near major international financial centers such as London and New York although the actual fund is registered in an OFC.

The Regulatory Edge

Offshore funds generally are not subject to U.S. Securities & Exchange Commission (SEC) regulations. As offshore funds generally are not registered in the United States or with the SEC, they offer privacy benefits and a variety of tax advantages. Interests in offshore funds generally cannot be sold or solicited in the United States or to any United States citizen abroad. Not all funds are authorized for sale or exempt from registration or qualification in all countries.

Regulation S

Offshore funds can rely on Regulation S to avoid registration under the Securities Act of 1933. As long as the offer and sale of a security is outside the United States, the offshore fund is exempt from SEC rules. This reflects the view that when securities come to rest outside the United States they are not subject to U.S. registration. This “issuer safe harbor” can be relied on if the offer or sale is made in an offshore transaction (the offeree is not in the United States and the buyer is outside the United States) and no directed selling efforts are made by the fund or its agent in the United States. For purposes of the issuer safe harbor, sales of fund shares to a professional fiduciary in the U.S. acting for a non-U.S. person as well as sales to certain international organizations or their pension funds generally are considered made in an offshore transaction. Directed selling efforts include actions intended or expected to condition the U.S. market for fund share.

The Tax Advantage

The key reason for being offshore is that gains are either untaxed or very lightly taxed in the country where they are created. Additionally, the regulatory regime in these countries is less burdensome than that of the high-tax countries where the investors, money managers and promoters (owners) of the fund are located.

The advantage of an offshore fund is that the investors in the fund generally are not subject to United States taxation. They are not subject to U.S. income or withholding taxes on distributions received from the fund or to U.S. estate taxes on fund shares. Offshore hedge funds generally are exempt from withholding taxes because the funds are located outside the United States.

Who Invests offshore?

Offshore investors will prefer to invest into an offshore corporation. Most nonresident aliens (NRAs) are eligible investors. These are individuals who are both non-U.S. citizens and non-U.S. residents and who are generally present in the United States fewer than 180 days a year. Offshore funds are also attractive to tax-exempt investors, such as certain not-for-profit institutions and retirement funds.

U.S. taxpayers generally prefer to be in a domestically organized vehicle that is a flow-through entity for tax purposes, such as a limited partnership or a limited liability corporation where the profits "flow through" to the investors, who are responsible for paying any taxes due. U.S. investors have been discouraged by their tax advisers' form investing in offshore funds because of certain tax rules which are designed to minimize the benefits of tax deferral.

Tax Exempt Investors

One popular impetus to setup an offshore fund is the case of the tax-exempt investor. Under the U.S. income tax laws, a tax exempt organization (such as an ERISA plan, a

foundation, an endowment, etc.) engaging in an investment strategy that involves borrowing money is liable for a tax on “unrelated business taxable income” (UBTI). This is true even though the investor is otherwise tax exempt, which presents not only an income tax issue for the plan but also a political one as well (i.e., the need to explain why a tax exempt fund is paying income tax). As U.S. funds are almost entirely made up of pass-through entities, such as the limited partnership or limited liability company structures, the UBTI activity passes through the entity to the tax exempt investor, thereby giving rise to the tax issue. Taxable investors are not concerned because they need to pay tax in any event. However, tax-exempt investors are quite concerned. The UBTI tax can be avoided by arranging for the tax-exempt entity to invest in a non-U.S. corporate structure. (Offshore funds are almost entirely corporate in nature.) The UBTI gets blocked, so to speak, at the wall of the corporation and therefore is no longer problematic for that type of investor. As a result, tax-exempt investors wishing to participate in the alternative investment market understand this aspect of the marketplace and are amenable investing offshore. Note that there are also ERISA issues that need to be considered.

Who Sets-Up Offshore?

Many investment fund managers want to know when the time is right to set up a hedge fund operation outside of the United States. Our response is usually a series of questions: Where are the client's investors coming from, where do they reside and what matters to them? What special needs might the trading strategy of the manager present? What needs might the investment fund manager have to establish an offshore fund?

If, after careful analysis, it is determined that there is an investor base from non-U.S. sources and/or a potential investor group that is U.S.-based but of a tax-exempt nature, then forming an offshore hedge fund could be a good idea. Because of the complexity of the U.S. tax and securities laws, and in view of the many information-sharing treaties between the U.S. and other nations, it is fairly common to conclude that non-U.S. investors will not invest in hedge funds that are based in the United States. Such investors much prefer non-U.S. locales.

Many investment fund managers do, in fact, maintain both U.S. and non-U.S. operations. Many U.S. based traders will set up an offshore fund to function as a counterpart with an identical investment strategy to its U.S. counterpart. In terms of day to day trading, the offshore fund trades in pari passu with domestic funds or accounts managed by the same trader. Some traders use a master feeder fund structure to simplify allocation and other trading issues. Given the global nature of the investment financial community, investment fund managers want to have both types of investment vehicles so that they attract all kinds of investment dollars.

The Profit Potential

Performance fees earned by offshore fund managers are a true fee and not an allocation of profits as is usually the case in U.S. funds. Many U.S. based fund managers establish arrangements to defer a portion of their management and incentive fees. The fund

manager may want to ensure that the offshore fund has provisions to allow deferral of management and incentive fees. This will allow the manager to defer his or her fees for a predetermined period and allow them to grow along with the fund on a tax-deferred basis. The manager can make a binding election to defer the fee for a state period of time. The deferred fee is a debt of the fund subject to the claims of the fund creditors

It is important to understand that the election to defer has nothing to do with the fact that the entity is offshore, but rather that it is not a flow-through vehicle. Were it a flow-through vehicle, the fees would not be reflected as expenses for tax purposes, and the investors would be paying tax on profits associated with these fees (particularly incentive fees). Deferral of compensation is a standard tool in compensation plans in the United States and is particularly valuable to implement in the context of an offshore fund.

Forming an Offshore Fund

Correctly structuring an offshore hedge fund is of critical importance and is a major determining factor in its overall success. There are six major issues that must be addressed. These issues pertain to tax issues, regulatory matters, day-to-day business management, investment strategies, marketing and back-office operations. Addressing these areas prior to creating an offshore hedge fund (or funds) eliminates problems later. It is important to understand that these are all closely related.

The typical offshore hedge fund manager seeks to create a financial investment for high net worth and institutional investors. The key distinction with respect to offshore funds is that they are not retail, publicly offered investment products (which would be subject to more stringent regulatory requirements).

Many believe that creating and managing an offshore investment vehicle is an extremely complicated and expensive process. It can be both, but doesn't have to be. Offshore funds are typically set up as a corporation, such as an international business company (IBC) or an exempted company. An offshore fund is governed by a Memorandum of Association and Articles of Association.

Most offshore funds require a board of directors, a fund manager, an administrator, and custodian. Directors can be the fund manager. Most OFCs allow for the directors to be anyone. Typically, an offshore fund enters into a contract with the fund manager, who may be based abroad or in the United States. If the fund is required to have a foreign based fund manager, the fund manager usually enters into a subcontract with a U.S. based trader to manage the fund. An offshore administrator usually handles the fund's day to day activities of operating the fund's bank account, issuing payment instructions, providing the net asset calculations, calculating management and performance fees, receiving and processing subscriptions, maintaining the shareholder register, preparing accounts, arranging payment of redemption proceeds, coordinating communications with shareholders, and overseeing antimoney laundering compliance. Although all of these activities can be performed in the United States without triggering U.S. tax issues, many of these functions are still performed outside the United States.

Offshore Fund Locations

Ask where a hedge fund is domiciled and you are likely to hear the name of a handful of places worldwide. In the United States, domestic hedge fund businesses tend to cluster in a few states, in particular California, Delaware, Connecticut, Illinois, New Jersey, New York and Texas. Each state has different tax and regulatory laws. Outside the United States, several centers in the Caribbean and Europe present different benefits and costs to fund managers. Regulatory burdens and expenses can be worth bearing, depending on the nature of the investment vehicle and its clients. A key distinction is sometimes forgotten. The domicile of the fund need not be the same as that of its administrator and custodian. A fund's service providers can hail from the other side of the world. Moreover, the service providers' jurisdiction sometimes turns out to be the more important issue.

A manager planning a new fund needs to answer a few key questions in order to decide where to register-what kind of investor the vehicle is for, where those investors are and what they want in a domicile. Experienced alternatives investors typically are less worried about domicile than first-time investors. Funds designed for mass distribution to the retail market need to have more regulation than those meant for wealthy individuals who are already in hedge funds. Some institutions may be bound by rules that limit investment to regulated jurisdictions, while others face no such requirement. But single-strategy managers continue to gravitate to traditional Caribbean locations and Bermuda, where costs are lower and the regulatory burden lighter than in Dublin and Luxembourg. Basic administrative fees are similar in all jurisdictions, but regulatory oversight adds to the expense in the European centers. For instance, in Dublin funds need to have a custodian, which is not the case in the Cayman Islands. While banks and large fund companies like to have regulations for their retail vehicles to reassure investors, the majority of hedge fund managers are small operators, for whom the extra costs can be a major burden.

There are many areas of the world that are considered primary offshore centers for forming hedge funds. The most widely used places are Bermuda, the Cayman Islands, Guernsey, Hong Kong, the Isle of Man, Jersey, Luxembourg, the British Virgin Islands and Dublin. These countries provide a welcoming environment for funds.

Bermuda: www.bma.bm

Any fund wanting to incorporate in Bermuda has to be approved by the Bermuda Monetary Authority. The investment manager, as well as the administrator, prime broker, custodian and auditors, are subject to BMA approval. Any change of service providers requires the prior consent of the BMA. The authority conducts due diligence on proposed service providers and investment manager personnel, including background checks in databases, for instance to find out whether there has been any legal action or NASD or SEC disciplinary sanctions against such individuals. In addition, a Bermuda incorporated fund is required to file monthly reports with the BMA, providing financial information such as the fund's net asset value, change in NAV from the prior month, amounts of

monthly subscriptions and redemptions and number of securities outstanding. The administrator usually makes these filings. Incorporation can take longer in Bermuda because of BMA approval rules-but that includes preparation of offering documents and service provider agreements, which as a practical matter have to be ready before the fund can commence operation in any case. In Cayman fund incorporation can occur earlier in the process, but afterwards time has to be spent preparing documentation.

British Virgin Islands www.bvi.gov.vg/

More than 2,000 mutual funds worth an estimated \$55bn are currently incorporated in the BVI, while several hedge funds are here. In all, 11 banks operate on the BVI, catering mainly for high net-worth wealth and trust management. The government launched new laws to placate the international community's concerns over financial regulation.

Cayman Islands www.cayman.gov.ky

The Cayman Islands is one of the world's lowest tax domiciles with no personal or corporate taxes. Registering in the Cayman Islands does not involve much due diligence by the Cayman Islands Monetary Authority during the incorporation process, but is not necessarily cheaper or faster overall. Cayman does not require monthly reports or prior consent to change service providers, but before a fund can commence trading, it has to be registered with CIMA under the Mutual Funds Law (subject to some exceptions). This means identifying all service providers to the fund and providing certain information about the fund and the offering of its securities, and CIMA has to be notified of any subsequent changes. However, currently the Cayman Islands do not require a fund to file regular reports with CIMA.

Gibraltar www.fsc.gi/fsc/home.htm

Gibraltar caters mainly to the banking, fiduciary and wealth management needs of southern Spain and Portugal. Gibraltar is a small jurisdiction (bank deposits total \$3.5bn) and has no real fund management industry.

Guernsey www.gfsc.guernseyci.com

The Channel Island of Guernsey fits the image of an "offshore financial centre" well. It offers a comprehensive range of financial services for banking, wealth and fund management, and fiduciary administration. Is developing as a leading private banking hub, and the latest figures show deposit and fund levels are at an all time high. Guernsey, like most centers, says that its regulation and know-your-customer rules are better than most financial centers.

Hong Kong www.hkma.gov.hk

Hong Kong has yet to hit former glory but continues to be the region's key financial centre for banking, asset management and low- tax trust and company admin. Over 60 of the world's largest banks are here.

Isle of Man www.gov.im

The Isle of Man is still a small player but has been one of the most successful offshore centers for growth. Three industries are zero-rated for tax in the Isle of Man: shipping, insurance and fund management. The island plans to become a low tax hub for e-commerce companies.

Jersey www.jerseyfsc.org

Jersey boasts a well-established banking, wealth management, fiduciary and fund financial services industry for expats. Joined Guernsey in defense against heavy-handed attacks on financial regulation and has refused to play ball unless other countries do so too. Around £250bn is invested in financial institutions and finance contributes around 60 per cent of government tax revenues.

Liechtenstein www.bankenverband.li

Until 2001, Liechtenstein was one of the most secretive financial centers. The country's 12 banks manage about \$70bn.

Luxembourg www.bcl.lu

The world's largest offshore fund's domicile with \$800bn is also one of the biggest offshore banking and wealth management centers handling about \$600bn. Banks operate like Swiss rivals, with strict client confidentiality and secrecy rules.

Switzerland www.snb.ch

The concept of "Swiss banking", an expensive luxury for high-net-worth individuals, is nevertheless under fierce competition from cheaper jurisdictions such as the Channel Islands. Poor equity markets and general performance are making many ask if Swiss wealth management is ultimately worth the cost.

The Bahamas www.bfsb-bahamas.com

The Bahamas is a very low tax jurisdiction. Banking, wealth and asset management are core industries, with around \$200bn under management. The island also boasts some 700 mutual funds with around \$100bn.

Don't Go Offshore If...

Going offshore to avoid U.S. taxation is the wrong reason to consider an offshore fund. Please note that money-laundering investigations are now a central element of the Internal Revenue Service's crackdown on abusive offshore financial arrangements, such as monetary funds and trusts. Defendants charged with money-laundering face stiffer penalties and longer prison sentences than persons charged with tax evasion. Federal prosecutors are increasingly charging criminals on both counts. Many lawyers and prosecutors now think foreign tax evasion can be tried as a money-laundering offense. Prior to the Sept. 11 attacks on the United States, information exchange and money laundering were topics of increasing concern and focus. The primary government initiatives, however, were in the tax administration arena.

Conclusion

From the time a manager instructs counsel to commence the organization of a fund to finalizing all documents (the offering memorandum, service provider agreements and constitutive documents), opening bank and brokerage accounts and registering the fund and being ready to commence trading, it is generally going to take four to five weeks. No comparative database is available on how many hedge funds are registered in each jurisdiction, but administrators who work with numerous managers think that there are still significantly more offshore funds domiciled in the Cayman Islands than other island centers. There may be fewer new funds being established in the British Virgin Islands. As managers increasingly focus on institutional investors, which typically prefer more regulation, more may choose Bermuda because it is likely to satisfy such clients. On the other hand, all offshore jurisdictions are waiting to see what happens in the United States following the much-watched SEC examination of hedge funds and the possibility of regulation of U.S. hedge funds and their managers. If that happens, it is possible that offshore jurisdictions will follow suit. The future could also bring changes in tax rules and corresponding shifts in the distribution of hedge funds across jurisdictions. Bermuda, BVI and the Cayman Islands are all British overseas territories, and as such are under pressure from the British government to impose more taxes.

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