

Offshore Hedge Funds vs. Onshore Hedge Funds

I. Who May Invest In Offshore Hedge Funds

Investors in offshore hedge funds are comprised of non-U.S. individuals and institutions as well as U.S. tax-exempt institutions. Institutional investors include entities such as pension funds, endowments, foundations, and other pools of capital whose assets are managed by a group of fiduciaries. Since offshore funds operate on the assumption that the assets they accept are not subject to taxes in the investor's home jurisdiction, they have no obligation to compile the information needed for an investor to calculate and pay taxes. This means that for practical purposes, U.S. taxable investors are prevented from participating directly in offshore funds, because although they would be legally obligated to report and pay tax on any taxable income earned in the fund, their fund manager would be unlikely to supply them with the relevant information.

II. General Structural Differences Between Onshore and Offshore Hedge Funds

A. Onshore Hedge Funds

Most hedge funds domiciled in the U.S. are organized as limited partnerships. This is because the limited partnership structure avoids double taxation of investment returns and grants investors (limited partners) limited liability protection, which shields them from losing more than their investment. The general partner is the fund manager and assumes responsibility for management of the fund's portfolio as well as management of the business of the partnership. As a prudent business practice, fund managers will typically form corporate entities to assume the role of general partner since the general partner has unlimited liability for the partnership's obligations.

B. Offshore Hedge Funds

In the offshore arena, hedge funds make use of three main vehicles: companies, unit trusts, and limited partnerships. The type of vehicle used is based on investor requirements.

1. Offshore Companies

The vast majority of companies are incorporated with limited liability. Some companies may have more than one class of shares, which denote various fee structures and/or denote limitations on the types of investments some shareholders can make. There may also exist multiple series within each class of shares.

Companies are the most common offshore vehicle for both open-end and closed-end funds. Open-end funds do not have a fixed number of shares. The number of shares in the fund increases when investors add capital to the fund and decreases when current investors withdraw capital from the fund. Closed-end funds have a fixed number of shares in which existing investors sell shares to new investors and buy shares from leaving investors. Closed-end funds may also have a tender process whereby the fund offers to buy shares from fund investors on a periodic basis. This has the effect of adding some liquidity to the fund but not nearly the level of liquidity that exists in open-end funds.

2. Offshore Unit Trusts

Formed under a trust deed, a unit trust is an unincorporated mutual fund structure. All unit trusts are open-ended. When investors in a unit trust add funds to their account, they are held by a trustee who has the option of acting as the custodian or selecting another custodian. The trustee must also make sure that the fund manager sticks to the fund's investment objectives and performance goals. Fund managers often charge an annual management fee of 1 to 2 percent of the fund's market value.

Assets typically held by unit trusts include property, securities, mortgages, and cash equivalents. Profits from these investments in the form of capital gains, interest, and dividends are paid out tax-free to investors rather than being reinvested back into the fund. Some onshore investors may have to pay taxes on their profits, but a grace period allows them to collect interest on those profits until their tax bill is due.

Offshore unit trusts have continued to grow in popularity for several reasons. In addition to offering favorable tax treatment, they typically have low annual operating expenses and are a cheaper investment vehicle than actively managed mutual funds even though they may charge sales, entrance, and/or exit fees. Moreover, they offer an easy way to diversify, which helps reduce investment risk.

Rather than offering the same investment portfolio to all of its investors, many unit trusts are happy to play the role of a one-stop shop by allowing investors to build and diversify their own portfolios across different asset classes, industries, and markets throughout the world. So instead of investors scattering their money over multiple investment products from multiple hedge funds, many of them prefer the convenience of turning to one fund for one product that can be tailored to suit their needs. Since each investor in the fund can be expected to have different risk tolerances, different performance goals, and different investment strategies, asset allocations will not be uniform throughout the fund's portfolios.

Hence, many offshore unit trusts must act as "umbrella" trusts that encompass several smaller "sub-trusts" (or "series trusts"), each of which represents a single investor's portfolio. The main "umbrella"

unit trust must be carefully structured so that the assets and liabilities of each sub-trust are considered separate from the assets and liabilities of other sub-trusts.

As an aside, holding units in a unit trust may be more attractive than holding shares in a company in some jurisdictions. It is possible that local regulations may not consider the units to be securities under their domestic securities laws. It is also possible that the jurisdiction may not even recognize concept of a trust.

3. Offshore Limited Partnerships:

By dividing the functions of ownership and control, limited partnerships are very effective at protecting assets from seizure by creditors.

Private equity funds with a limited number of investors will often make use of offshore limited partnerships. Regarding the Cayman Islands specifically, the offshore limited partnership vehicle is very popular among U.S. investors who tend to already be familiar with Delaware limited partnerships which the Cayman limited partnership structure is based on.

III. Various Purposes for Offshore Funds

A. Accommodating Tax-exempt Investors Interested in Avoiding UBTI

Under U.S. tax law, a tax-exempt organization (such as an IRA, ERISA-type retirement plan, foundation, endowment, etc.) that adopts an investment strategy where money is borrowed is liable for a tax on “unrelated business taxable income” (UBTI). This presents an income tax issue for the plan as well as a political issue, because it raises the question of why a tax-exempt fund would have to pay income tax. Since pass-through entities such as limited partnerships and limited liability companies comprise the overwhelming majority of U.S. funds, the UBTI activity passes through the entity to the tax-exempt investor, which triggers the tax issue. Taxable investors are not bothered by this, because they have to pay tax anyway. However, it is a cause for concern for tax-exempt investors. By having the tax-exempt entity invest in a non-U.S. (offshore) corporate entity (which is non-pass through), the UBTI tax can be avoided, because the UBTI is effectively trapped inside the corporation and no longer causes trouble for the U.S. tax-exempt investor. Consequently, tax-exempt investors are willing to invest offshore in order to deal with this issue.

B. Non-U.S. Investors Concerned About Maintaining Anonymity

Offshore hedge funds organized as corporations are attractive to non-U.S. investors seeking to maintain anonymity with respect to the U.S. For example, if an offshore hedge fund makes any investments in

U.S. securities, then U.S. withholding tax rules will apply to the fund and U.S. paperwork will have to be filled out to claim exemption from U.S. withholding and backup withholding taxes. If the offshore fund is structured as a partnership, the partners themselves will have to submit these forms, which declare their participation in the fund to U.S. tax authorities. However, if the offshore fund is structured as a corporation, then only the corporate entity will have to submit the paperwork, thus allowing its individual non-U.S. investors to remain anonymous to U.S. tax authorities.

C. Master-Feeder Fund Structure

It is common for hedge fund managers to offer both an onshore U.S. limited partnership for taxable U.S. investors as well as an offshore company for tax-exempt U.S. investors and non-U.S. investors, who wish to avoid the U.S. tax regulatory net or to remain anonymous to U.S. authorities. Arranging the investments of two separate funds so that each fund has the same asset allocation and is pursuing the same investment strategy can be very difficult. This problem has been solved through the development of the “master-feeder” fund structure in which the onshore U.S. limited partnership and the offshore company act as “feeder” funds and invest all their assets in an offshore “master” fund company, which conducts all trading. Pooling the assets into a master fund helps to increase the total amount of tradable assets, achieve economies of scale, and enhance operational efficiencies.

IV. Jurisdictional Comparison Between the British Virgin Islands and the Cayman Islands:

A. Cayman Islands:

Significant tax and regulatory advantages exist for hedge funds domiciled in the Cayman Islands. For starters, there are no direct taxes of any kind. A government mandate allows exempted companies, which are the most common fund vehicles, to remain tax-free for 20 years. Unit trusts (popular with Japanese investors) and exempted limited partnerships are allowed to remain tax-free for 50 years. Exempted limited partnerships in the Cayman Islands are popular with U.S. investors as they bear much resemblance to the Delaware limited partnerships they are already familiar with.

There are no exchange control restrictions, which allow investment funds to flow freely in and out of the country. The Cayman Islands Monetary Authority (CIMA) is the sole authority for registration and regulation of funds that fall subject to the Mutual Funds Law, which was most recently revised in 2007. There is no requirement for companies to hold annual meetings. There are no restrictions on the issue of equity interests except for registration with CIMA. There are no restrictions on a fund’s ability to appoint prime brokers or custodians.

Close to 87% of all listings on the Cayman Islands Stock Exchange (CSX) are made up of investment funds. The CSX has plenty of experience in listing investment funds such as hedge funds, umbrella

funds, mutual funds, feeder funds, and various specialist funds. Should someone want to establish a hedge fund in the Cayman Islands, there is a vast pool of talented and experienced people in the fields of accounting, law, fund administration, and backoffice-type support ready to help out.

The independent legal and judicial system has traditionally been based on a combination of English common law and local legislation. Caymanians seek to preserve these traditions while also keeping up-to-date with accepted standards of international finance. The Cayman Islands' Government and the private sector each have a vested interest in working together to ensure the country maintains and strengthens its role as a major international financial center.

B. British Virgin Islands (BVI):

The British Virgin Islands (BVI) has experienced tremendous growth as an offshore financial center since it first sought that status in the early 1980s. Close to 750,000 companies have registered in the BVI since 1984, which far surpasses any other jurisdiction. The BVI has a long-established reputation as the leading offshore jurisdiction for international companies.

As is the case in the Cayman Islands, the public and private sectors in the BVI work closely together to lay the foundations for its future growth as an offshore financial center. It is standard practice for the government to review old legislation to ensure it is still relevant. A recent example of this took place with the enactment of the Business Companies Act in early 2006, which replaced the long-established International Business Companies (IBC) Act. The new Act got rid of sections that were considered to be outdated or irrelevant. It sought to allow for more flexibility for directors and shareholders of BVI registered companies while also maintaining protections for creditors and minority shareholders. Additionally, the new Act grants fund managers the ability to make use of Segregated Portfolio Companies.

The hedge fund industry greatly expanded following the passage of the 1996 Mutual Funds Act. Today, the BVI has an established base of over 500 fund managers and administrators. Efficient regulations have lowered the costs of establishing and operating a fund in the BVI and have caused both large and small funds to consider making the BVI their new home. Investors in East Asia, in particular, have acknowledged the BVI's clout in the arena of offshore financial centers.