STRUCTURING OFFSHORE HEDGE FUNDS

HEDGE FUND
fundamentals

Contents

Overview:

A principal concern when structuring a hedge fund is to provide the most favorable tax result for the investors and the fund manager itself.

Because U.S. corporations are subject to income tax on investment income as well as business income, tax-exempt U.S. investors prefer to invest in non-U.S. corporations, which are not subject to income tax in the jurisdiction in which they reside and which generally can avail themselves of a safe harbor from U.S. taxation if they receive only investment and trading income.

This presentation focuses on the structure of offshore vehicles and the general business and regulatory environment in popular offshore jurisdictions, such as the Cayman Islands, the British Virgin Islands, Bermuda, and Ireland.

Table of Contents:

U.S. Treasury Circular 230 Notice: Any U.S. federal tax advice included in this outline was not intended or written to be used, and cannot be used, for the purpose of avoiding U.S. federal tax penalties.

Structuring Offshore Hedge Funds

How are Hedge Funds Structured?

In structuring a hedge fund, a principal concern is to provide the most favorable tax result for the investors and the fund manager itself.

The factors which hold the largest impact on the chosen structure are the fund's investment program and the types of investors who will invest in the fund.

The fund manager will seek to utilize entities domiciled in jurisdictions which have clear and predictable laws, quality service providers, and are familiar to investors.

Categories of Investors

The main categories of investors are:

- Taxable U.S. investors (e.g., individuals and family partnerships)
- Tax-exempt U.S. investors (e.g., pension funds, foundations and endowments)
- Non-U.S. investors. (e.g., individuals and institutions)

In order to address the concerns of each of the foregoing types of investor, a fund manager generally will offer both a U.S. vehicle and an offshore (non-U.S.) vehicle.

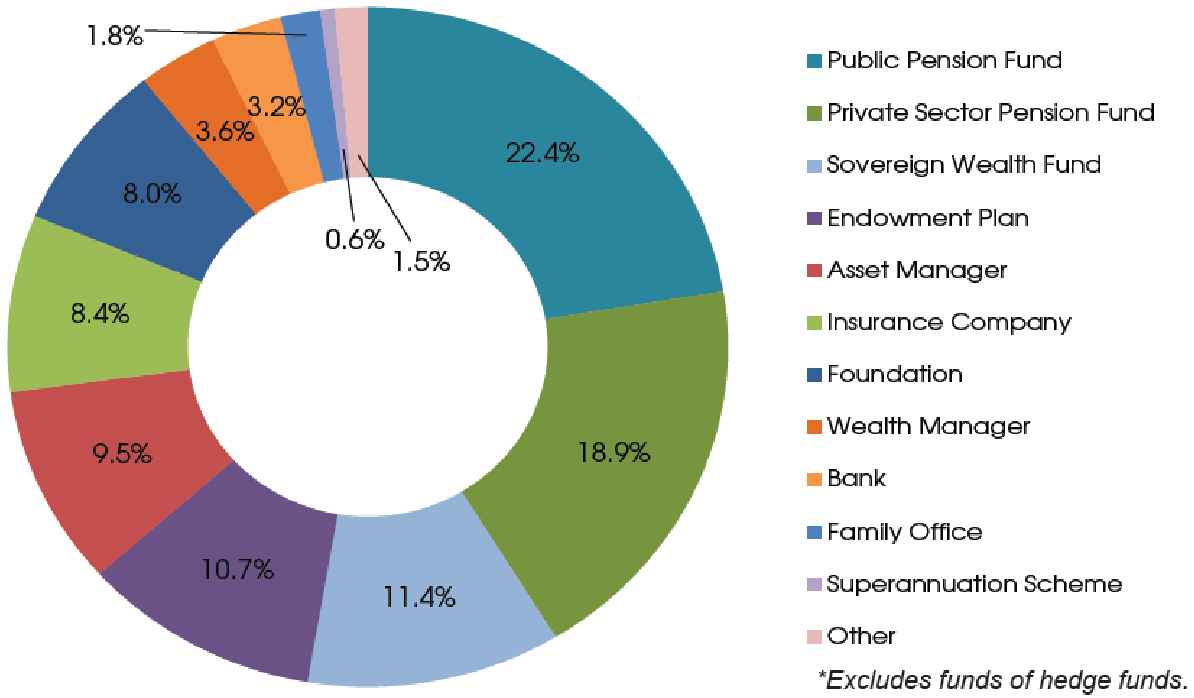
This presentation focuses on the structure of offshore vehicles and the general business and regulatory environment in popular offshore jurisdictions, such as the Cayman Islands, the British Virgin Islands, Bermuda, and Ireland.

U.S. - Domiciled Vehicle

Offshore Vehicle

Hedge Fund Investor Composition*

A majority of hedge fund investors are tax-exempt institutional investors.



*Based on Institutional Capital

Source: 2014 Preqin Global Hedge Fund Report, January 2014.

Taxable U.S. Investors

It is Not Often Efficient for Taxable U.S. Investors to Use Offshore Funds.

Taxable U.S. investors include:

- Natural persons
- Partnerships
- Corporations
- Trusts
- Limited liability companies (LLCs)
- Registered investment companies

Taxable U.S. investors generally prefer to invest in U.S. domiciled limited partnerships and LLCs, which are "pass-through" entities that are not subject to entity-level taxes, but instead pass their gains and losses through to their investors. This allows taxable individual U.S. investors to take advantage of capital gains treatment (a lower tax rate) on their investments where available.

In most cases, it would not be efficient for U.S. investors to invest in offshore funds, because most offshore funds are treated as passive foreign investment companies (PFICs) under the tax code, and are taxed at a higher rate with the ability to take losses deferred.

Tax-Exempt U.S. Investors

Pensions

Endowments

Foundations

Tax-exempt U.S. investors include government and corporate pension plans, profit sharing plans, IRAs, Keogh plans, endowments, foundations, and other charitable organizations.

Why Do Some Investors Go Offshore?

Tax-exempt U.S. investors are generally exempt from paying federal income tax, other than with respect to debt-financed income and business income (as opposed to investment or trading income). Such income is referred to as "unrelated business taxable income," or "UBTI."

A tax-exempt U.S. investor can generally avoid UBTI by investing through a “blocker” – a corporate entity where the character of the income (such as UBTI) does not “flow through” to the investor as it does with U.S. pass-through entities. Rather, the corporate entity is the tax payer.

Because corporations in the U.S. are taxed up to 35%, tax-exempt U.S. investors prefer to invest in a corporation in a non-U.S. jurisdiction where there is no entity-level taxation, which allows them to maintain their tax-exempt status while protecting them from incurring UBTI.

Offshore Jurisdictions – Why Do Hedge Funds Set Up Entities in the Cayman Islands?

Countries such as the Cayman Islands, Bermuda, Ireland, and the British Virgin Islands are popular choices for setting up offshore hedge funds because they:

- Charge no, or low, entity-level taxation.
- Have a robust regulatory regime, including anti-money laundering measures and bank regulations.
- Have a developed financial industry that can supply qualified service providers (licensed by local governmental authorities) to serve as legal counsel, administrators, auditors and directors of hedge funds.

Many of these jurisdictions operate as British Overseas Territories and utilize a common law legal system which provides a familiar foundation in entity and contractual law that makes them attractive jurisdictions for investors looking to invest abroad.

Breakdown of Hedge Fund Domiciles

Fig. 5.15: Breakdown of Domiciles Used by North America-Based Hedge Funds

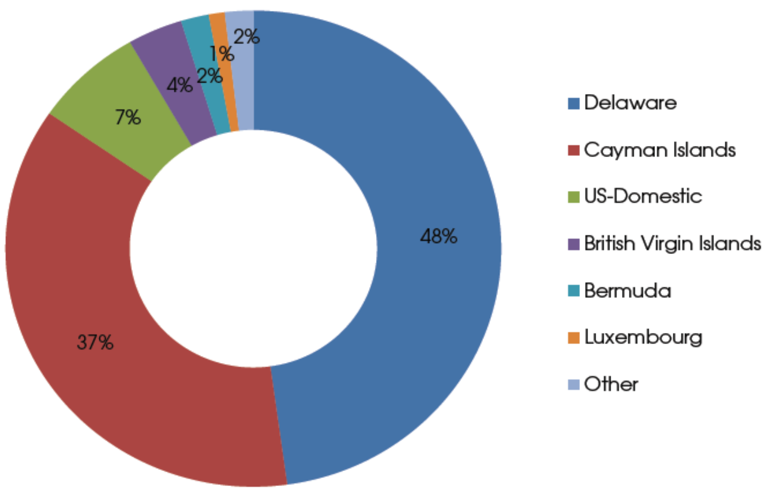
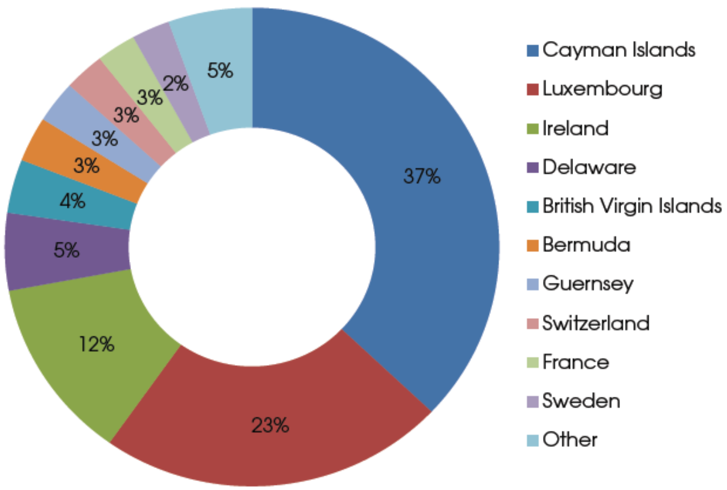


Fig. 5.16: Breakdown of Domiciles Used by Europe-Based Hedge Funds



Source: 2014 Preqin Global Hedge Fund Report, January 2014.

Anti-Money Laundering and Other "Know Your Customer" Regulation and Supervision

The popular offshore jurisdictions have robust anti-money laundering regimes and cooperate with international regulatory authorities, including the Organisation for Economic Co-operation and Development (OECD), Financial Action Task Force, and International Monetary Fund, to adopt "best practice" international regulatory standards.

They are party to multiple international treaties to combat bank secrecy, as well as agreements with numerous other countries (including the U.S. and U.K.) that require the exchange of information relating to taxes.

Fund bank accounts are usually kept at major U.S. and European banks or local branches of these banks, which subjects the fund and investors to an additional layer of anti-money laundering and other "know your customer" regulation and supervision.

Addressing the Concerns of Tax-Exempt U.S. Investors

Because U.S. corporations are subject to income tax on investment income as well as business income, tax-exempt U.S. investors prefer to invest in non-U.S. corporations, which are not subject to income tax in the jurisdiction in which they reside and which generally can avail themselves of a safe harbor from U.S. taxation if they receive only investment and trading income.

A non-U.S. corporation, however, is subject to U.S. withholding tax on U.S. dividends and certain other types of U.S. source income.

Tax-exempt U.S. investors do not pay U.S. tax on unleveraged investments in dividend-paying stocks owned through a flow-through entity.

Non-U.S. Investors

Non-U.S. Investors Generally Do Not Want to Incur U.S. Taxes

Non-U.S. investors include foreign natural persons and a variety of foreign entities.

Non-U.S. investors generally prefer not to be U.S. taxpayers or to file U.S. tax returns with respect to their investment activities, which generally would be the case if they invested in a U.S. entity or an entity which was a “pass-through” entity for U.S. tax purposes.

Similar to tax-exempt U.S. investors, non-U.S. investors generally prefer to invest in non-U.S. corporations because the corporate entity is the U.S. taxpayer and tax filer and can often benefit from the safe harbor from U.S. taxation (other than withholding taxes) if it receives only investment trading income.

Accommodating the Conflicting Needs of U.S. and Non-U.S. Investors in a Hedge Fund's Structure

As discussed, taxable U.S. investors generally prefer to invest in U.S.-domiciled pass-through entities, while tax-exempt U.S. investors and non-U.S. investors generally prefer to invest in offshore corporate entities.

As a result, hedge fund managers which seek to target all types of investors will typically set up a domestic fund as a U.S. limited partnership or limited liability company to accommodate U.S. taxable investors and an offshore fund as a corporation domiciled in a jurisdiction with no or low corporate income tax to accommodate tax-exempt U.S. investors and non-U.S. investors.

The domestic fund and the offshore fund are both managed by the fund manager.

Structuring Offshore Hedge Funds

How does a hedge fund accommodate the interests of different investors at the same time?

There are a number of structural approaches employed by hedge funds to accommodate different investors. Three basic structures – a stand-alone structure, a side-by-side investment structure and a master-feeder structure – are outlined below.

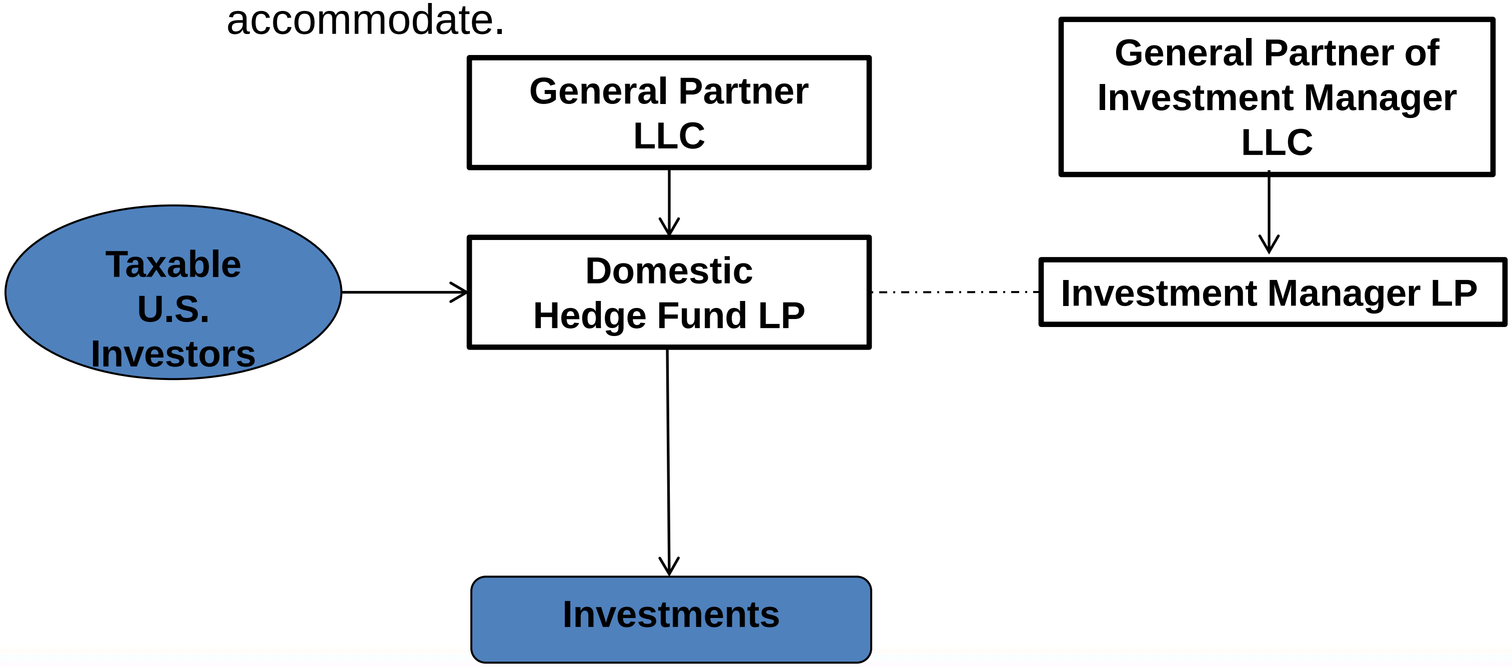
Hedge Fund Investment Structures:

Stand-Alone	**Side-by-Side**	**Master-Feeder**

Stand Alone Structure

In its most basic form, a hedge fund is a single entity, to which the investors contribute funds.

As a result of the considerations outlined above, a stand-alone structure is limited in the types of investors it can efficiently accommodate.



Side-by-Side Structure

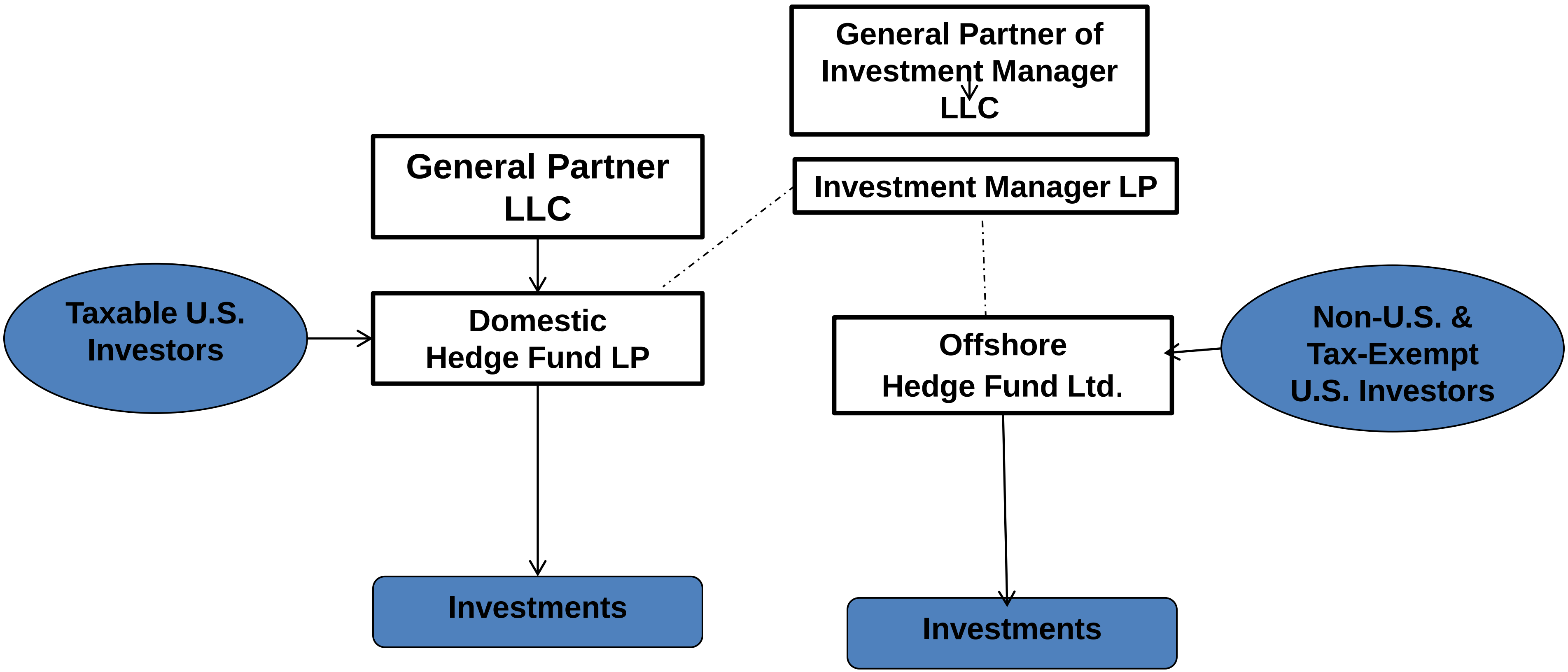
The side-by-side structure is a two-fund structure which includes a U.S. fund (e.g., a Delaware limited partnership) and an offshore fund (e.g., a Cayman Islands exempted company).

A side-by-side structure is often formed in order to address the concerns of each type of domestic and offshore investor.

The fund manager advises each fund in the side-by-side structure, and each fund makes the same, or substantially the same, investments.

Structuring Offshore Hedge Funds

Side-by-Side Structure



Advantages and Disadvantages of a Side-by-Side Structure

An advantage of the side-by-side structure is that, due to the segregation of taxable and tax-exempt U.S. investors into separate fund entities, tax and regulatory sensitivities (e.g., long-term capital gains holding periods) can be managed for a specific type of investor.

A drawback to the side-by-side structure is that it requires the fund manager to place separate orders for each fund (often at higher overall cost), and often portfolios are rebalanced between funds (e.g., when a fund's size changes due to subscriptions and redemptions).

Administrative and audit costs may also be higher due to maintaining two portfolios.

Master-Feeder Structure

In a master-feeder structure, like a side-by-side structure, a domestic fund and an offshore fund are established.

However, rather than each fund directly holding a portfolio of investments, each fund (known as a “feeder” fund) invests indirectly in a single portfolio through a master fund.

The master fund is a pass-through entity for U.S. tax purposes, which preserves the tax character of investments for taxable U.S. investors.

As a result, the fund manager makes a single investment decision which is then apportioned to the fund feeders, and then makes its way back to the various investors. The feeder funds participate indirectly in the master fund’s portfolio through their ownership of the master fund.

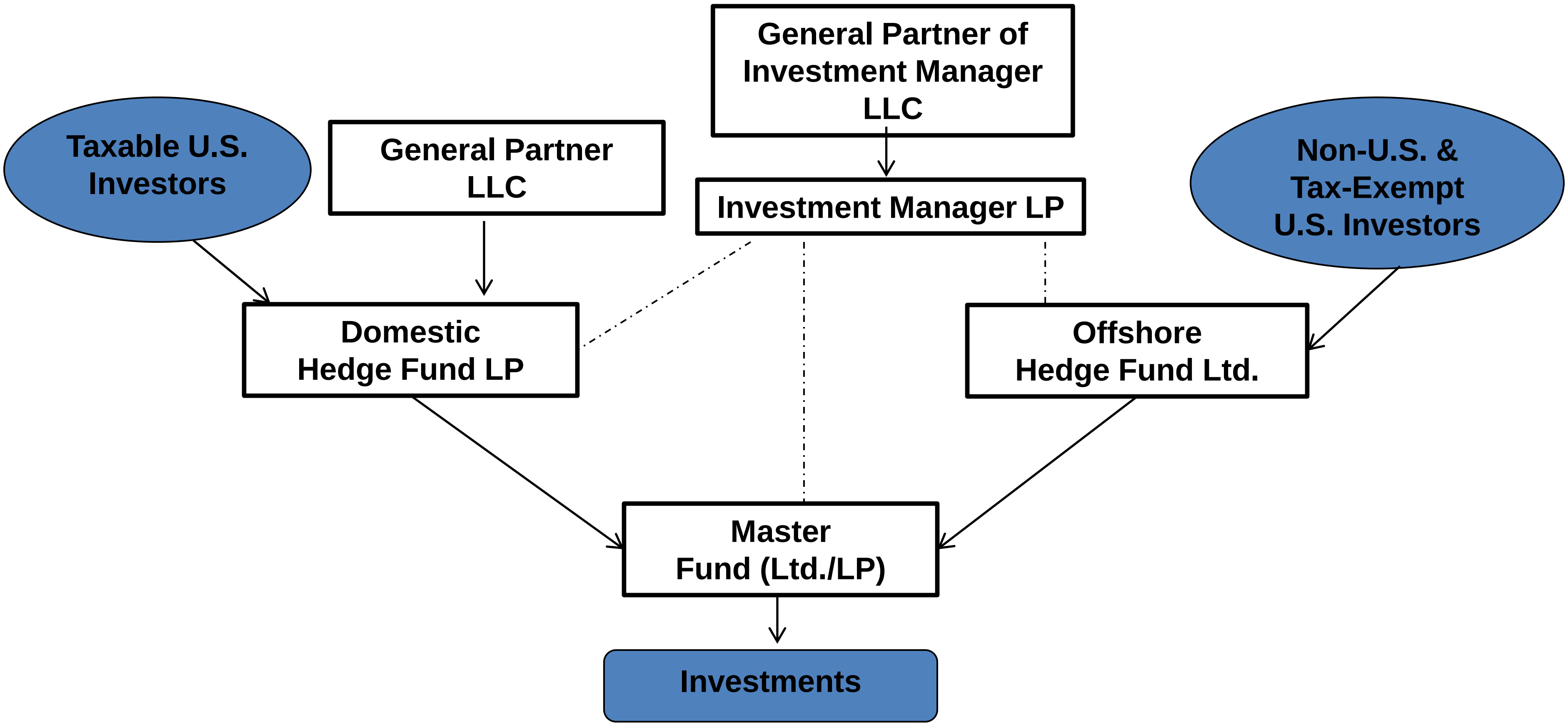
Master-Feeder Structure

A master-feeder structure tends to be efficient and cost effective from a portfolio and operational perspective.

However, the master-feeder structure can present conflicts of interest in cases where an investment may be tax-efficient only for either the domestic feeder fund investors or the offshore feeder fund investors. This can be addressed by having each feeder fund maintain the discretion to make direct investments, although it is rarely practical to do so.

Structuring Offshore Hedge Funds

Master-Feeder Structure



Acknowledgements

MFA would like to acknowledge Schulte Roth & Zabel LLP (www.srz.com) for their advice and counsel throughout the drafting process of this presentation. SRZ is a full-service law firm with offices in New York, Washington, D.C. and London. As one of the leading law firms serving the alternative investment industry, the firm regularly advises clients on corporate and transactional matters, as well as providing counsel on securities regulatory compliance, enforcement and investigative issues.