

Offshore Fund Taxation

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The number of offshore hedge funds has increased due to the ability of these funds to operate outside the scope of government regulation and disclosure requirements. Hedge funds are set up as offshore or onshore funds to allow for different groups of investors. U.S. based hedge fund managers who have significant potential investors outside the United States and/or U.S. tax-exempt investors typically create offshore funds. Many hedge fund managers use offshore hedge funds to provide privacy to investors. In those cases where complete investor confidentiality and privacy are necessary, an offshore fund should not accept U.S. investors and the fund manager should not be based in the United States.

For a new hedge fund manager who is a small operator and for whom the extra costs are a major burden, the best location to launch an offshore hedge fund or a master feeder fund is the Cayman Islands or the Bahamas. Both countries have tiered statutory regimes for hedge funds, allowing hedge funds to start out as unregistered funds and then later upgrading to registered fund status if necessary. Hedge fund attorneys in both countries are familiar with hedge fund start ups and will work with a new hedge fund manager. Related service providers (accountants, administrators, etc.) in both countries are good, with the Cayman Islands offering a greater number of service providers.

Master/Feeder Fund Structure

Confusing to some is the use of onshore and offshore funds in a master/feeder structure. The master/feeder structure allows a hedge fund manager to manage money for a broad spectrum of investors. The master fund, structured as an offshore corporation (but treated as a partnership for U.S. tax purposes via a check-the-box election), engages in all trading activity. A hedge fund manager will pool money and feed it in to a master fund and allocate trading gains and losses back to the onshore and offshore feeder funds based on the percentage assets under management in each feeder fund. A master/feeder structure typically includes (in addition to the master fund company) a U.S. limited partnership or limited liability company as the feeder fund for U.S. taxable investors and a foreign corporation as the offshore feeder for foreign investors and U.S. tax-exempt investors.

The master/feeder fund structure allows the investment manager to collectively manage money for varying types of investors in different investment vehicles without having to allocate trades and while producing similar performance returns for the same strategies. Feeder funds invest fund assets in a master fund that has the same investment strategy as the feeder fund. The master fund, structured as a partnership, engages in all trading activity.

In today's trading environment, a master/feeder structure will include a U.S. limited partnership or limited liability company for U.S. investors and a foreign corporation for foreign investors and U.S. tax-exempt organizations.

U.S. Tax Exempt Investors

The typical investors in an offshore hedge fund structured as a corporation will be foreign investors, U.S. tax-exempt entities, and offshore funds of funds. U.S. tax-exempt investors favor investments in offshore hedge funds because they may have exposure to U.S. taxation if they invest in U.S. based hedge funds. Under U.S. tax laws, a tax-exempt investor (such as an IRA, an ERISA-type retirement plan, a foundation, or an endowment) is liable for income tax on "unrelated business taxable income" (UBTI), notwithstanding its tax-exempt status. UBTI exposure exists when a U.S. tax-exempt investor invests in a hedge fund that uses leverage (*e.g.*, trades on margin).

The UBTI tax is avoided by investing in an offshore hedge fund. A U.S. based hedge fund manager should consider setting up an offshore fund if he or she manages money for foreign and/or U.S. tax-exempt investors. Although certain organizations, such as qualified retirement plans, generally are exempt from federal income tax, unrelated business taxable income (UBTI) passed through partnerships to tax-exempt partners is subject to that tax. UBTI is income from regularly carrying on a trade or business that is not substantially related to the organization's exempt purpose. UBTI excludes various types of income such as dividends, interest, royalties, rents from real property (and incidental rent from personal property), and gains from the disposition of capital assets, unless the income is from "debt-financed property," which is any property that is held to produce income with respect to which there is acquisition indebtedness (such as margin debt). As a fund's income attributable to debt-financed property allocable to tax-exempt partners may constitute UBTI to them, tax-exempt investors generally refrain from investing in offshore hedge funds classified as partnerships that expect to engage in leveraged trading strategies. As a result, fund sponsors organize separate offshore hedge funds for tax-exempt investors and have such corporate funds participate in the master-feeder fund structure.

U.S. Individual Investors

Offshore hedge funds are generally organized as corporations for marketing, tax, and legal reasons. Less frequently, offshore hedge funds will elect to be treated as a partnership for U.S. tax purposes to attract U.S. individual investors as well as participate in master/feeder fund arrangements. If U.S. taxable investors invest in or effectively control an offshore hedge fund, some complex U.S. tax rules applicable to controlled foreign corporations, foreign personal holding companies, or passive foreign investment companies (PFIC) need to be addressed. However, these rules are manageable when knowledgeable tax advisors are on board. If U.S. individual investors participate in an offshore hedge fund structured as a corporation, they may be exposed to onerous tax rules applicable to controlled foreign corporations, foreign personal holding companies, or passive foreign investment companies (PFIC). To attract U.S. individual investors, fund sponsors organize separate hedge funds that elect to be treated as partnerships for

US tax purposes so that these investors receive favorable tax treatment. These funds participate in the master/feeder structure. Under the U.S. entity classification (*i.e.*, check-the-box) rules, an offshore hedge fund can elect to be treated as a partnership for U.S. tax purposes by filing Form 8832, "Entity Classification Election," so long as the fund is not one of several enumerated entities that are required to be treated as corporations.

U.S. Reporting Requirements

An interesting issue that has arisen in the context of the master/feeder fund structure concerns the nature of U.S. reporting requirements. Section 6031(a) requires every partnership to file a partnership return, Form 1065. However, section 6031(e) provides that a foreign partnership is not required to file a return for a taxable year unless during that year it derives gross income from sources within the United States (US-source income) or has gross income that is effectively connected with the conduct of a trade or business within the US (ECI). Regulations issued pursuant to Section 6031 generally provide that a foreign partnership is not required to file a Form 1065, if the following two conditions are met:

1. The foreign partnership does not have gross income that is (or is treated as) effectively connected with the conduct of a trade or business in the U.S. (*i.e.*, no effectively connected income or ECI).
2. The foreign partnership does not have gross income (including gains) derived from sources within the United States (*i.e.*, no U.S.- source income).

With respect to a foreign partnership that is not a withholding foreign partnership (*i.e.*, a foreign partnership that has entered into an agreement with the IRS whereby the foreign partnership agrees to be subject to the withholding and reporting provisions applicable to withholding agents and payors), the critical inquiry in determining whether a US filing requirement exists is ECI. To the extent that a foreign partnership generates ECI, it is required to file Form 1065.

The test for determining whether a US partnership filing requirement exists in this context (*i.e.*, whether the partnership generates ECI) is dictated Section 864 and its regulations. In general, an offshore hedge fund is not considered to be conducting a trade or business within the United States merely by investing in the stocks or securities of U.S. issuers or by trading in such stocks or securities in the United States for its own account. In addition, an offshore hedge fund may retain the services of United States investment advisers and brokers and may grant them discretion to engage in securities transactions without causing the fund to be deemed to be conducting such a trade or business. A fund that is considered a "dealer" in stocks or securities of U.S. issuers, however, is considered to be conducting a trade or business within the United States. The determination of whether a fund's activities rise to the level of dealer activities depends on the facts and circumstances of each case.

Prior to the repeal of the statutory basis for the "Ten Commandments" by the Taxpayer Relief Act of 1997, an offshore hedge fund that traded in stocks or securities of U.S.

issuers for its own account was considered to be conducting a trade or business within the United States if it maintained its principal office in the United States. Regulations under Section 864 set forth a "safe harbor" list of ten administrative functions (Ten Commandments) that, if conducted substantially outside the United States, would tend to cause a fund to be treated as if its principal office were outside the United States. Although it is no longer necessary to comply with this safe harbor to avoid being treated as conducting a U.S. trade or business, many offshore hedge funds continue to maintain their books and records and perform certain other administrative functions offshore for privacy reasons and to avoid taxation in a handful of states that, in effect, have not adopted the repeal.

As for offshore hedge funds trading stocks and securities for their own account and not otherwise engaging in the conduct of a U.S. trade or business, foreign partners are subject to U.S. withholding taxes only on dividend income and nonportfolio interest income.

Reporting Rules for Foreign Partnerships Having No ECI

Regulations also contain three rules that modify the reporting requirements of offshore hedge funds that do not generate ECI. Except for the de minimis rule, the modified reporting requirements apply only when the following occurs:

1. The foreign partnership or one or more withholding agents files the required Form 1042, "Annual Withholding Tax Return for U.S. Source Income of Foreign Persons," (Form 1042 reports fixed or determinable annual or periodic (FDAP) income that a U.S. withholding agent receives, controls, has custody of, disposes of, or pays) and Form 1042-S, "Foreign Person's U.S. Source Income Subject to Withholding," (Form 1042-S reports the income paid and taxes withheld with respect to a foreign person as well as the withholding agent's identification information) for U.S.-source income allocable to foreign partners of the foreign partnership.
2. The tax liability of foreign partners with respect to that income must be fully satisfied by withholding of tax at source.

De Minimis Rule

The first modified rule for foreign partnerships that do not generate ECI is the de minimis exception. A foreign partnership with \$20,000 or less of U.S.-source income and no ECI is required to file a U.S. partnership return only if 1% or more of any item of partnership income, gain, loss, deduction, or credit is allocable in the aggregate to direct U.S. partners.

U.S.-source income but no U.S. Partners

The second modified reporting rule specifies that a foreign partnership with U.S.-source income but no ECI and no U.S. partners will not be required to file a U.S. partnership return.

U.S.-Source Income and U.S. Partners

The third modified reporting rule requires that a foreign partnership that has U.S.-source

income and one or more U.S. partners but does not have ECI must file a U.S. partnership return. The partnership, however, will be required to file Schedules K-1 only for its direct U.S. partners and for its pass-through partners through whom U.S. partners hold an interest in the foreign partnership. Thus, for foreign partnerships that generate only U.S.-source income but no ECI, the regulations do not require those partnerships to furnish Schedules K-1 for foreign partners, because the foreign partners are subject to information-reporting requirements on Form 1042-S under Treas. Regs. Secs. 1.1441-5(c) and 1.1461-1. These regulations subject the foreign partners (and not the partnership) to information-reporting requirements for U.S.-source income paid to a foreign partnership that is not ECI.

Reporting Rules for Foreign Partnerships Generating ECI

Unlike the rules in the regulations for foreign partnerships that generate only US-source income but no ECI, the exception to Schedule K-1 reporting for foreign partners does not apply to a foreign partnership that generates ECI. Specifically, a foreign partnership that generates ECI must file a complete U.S. partnership return of income, with Schedules K-1 for all partners, including foreign partners. Furthermore, that partnership must report to all foreign partners their allocable shares of ECI, as well as their allocable shares of all items of partnership income, gain, loss, deduction, and credit.

Partnership-Level Elections

The regulations provide simplified reporting rules for foreign partnerships that file U.S. partnership returns only for the purpose of making partnership-level elections. Generally, a partnership return filed only to make a partnership-level election need contain only a written statement referring to Reg. 1.6031(a)-1(b)(5)(ii), stating the name and address of the partnership making the election, as well as the specific election being made. For example, a foreign partnership that is not otherwise required to file a U.S. partnership return may choose to file a partnership return if the partnership has incurred organizational costs and seeks to elect to amortize these expenses over 60 months.

State Tax Concerns

Although offshore hedge funds generally will not have nexus to the states, many states still require partnerships to file state partnership tax returns if they have partners that are residents of their jurisdiction. This could result in an offshore hedge fund with U.S. partnership tax status being required to file a state tax return even though it arguably may not be required to file a Form 1065, since the partnership has no U.S.-source income and no ECI. For example, every partnership that has income or loss from sources in New Jersey or has a New Jersey resident partner must file Form NJ-1065. Thus, an offshore hedge fund with New Jersey resident partners will be required to file a New Jersey partnership tax return, regardless of whether the partnership has New Jersey-source income. Partnerships that have "resident" partners or have income from New York sources are required to file a New York State partnership return (Form IT-204). In accordance with these rules, an offshore hedge fund that has New York resident individual partners will be required to file a New York partnership return, regardless of whether the entity has a federal filing requirement. A partnership is required to file Form CT-1065, "Connecticut Partnership Income Tax Return," if it is required to file Form

1065 and it has any income, gain, loss, or deduction derived from or connected with Connecticut sources. Therefore, an offshore hedge fund will not be required to file Form CT-1065 simply because it has a partner who is a resident of Connecticut.

Conclusion

An offshore hedge fund that only trades for its own account and does not otherwise engage in a trade or business is not be required to file Schedules K-1 on behalf of foreign partners. As a result, the offshore hedge fund can file a U.S. partnership tax return to preserve the advantages of filing for U.S. partners (i.e., the benefits of a partnership-level election such as the amortization of organizational costs over 60 months) without compromising the anonymity of foreign partners. While an offshore hedge fund that has U.S. partners but no ECI and no U.S.-source income does not have a federal filing requirement, the partnership may be required to file state and local tax returns if its U.S. partners are residents of certain states. Such state and local partnership returns may require the identity of all partners (including foreign partners) to be included as part of the return. An offshore hedge fund electing partnership status should carefully analyze the connection of its activities to the U.S. and the residencies of its U.S. partners to properly ascertain its federal and state filing obligations, as well as provide proper disclosure as to the filing obligations to foreign partners.