



Alternative Investment  
Management Association

# Transparent, Sophisticated, Tax Neutral: The Truth About Offshore Funds



We are often asked to explain why a significant proportion of the world's alternative investment funds, including hedge funds and private equity funds, are set up in offshore jurisdictions such as the Cayman Islands. Is it to evade tax or hide assets? This brief note seeks to provide the answers. For further information, contact us at [info@aima.org](mailto:info@aima.org).

## Executive Summary

**Collective investment is good for investors.** Investors such as pension funds, sovereign wealth funds, not-for-profit organisations, charities and other similar entities (often called “sophisticated investors”) can either make alternative investments directly or invest via a collective investment scheme - a fund that pools monies from a number of sophisticated investors and then manages those monies on their behalf. The use of such a collective investment scheme gives investors significant benefits including (i) professional management with specific industry expertise, (ii) the ability to diversify their portfolios across a broad range of alternative investment strategies, (iii) sharing of investment expenses and (iv) access to alternative investment types which are outside the scope of even sophisticated investors acting alone. However, collective investment can also bring legal, regulatory and tax complications, which sophisticated investors wish to minimise in order to maximise returns to their stakeholders.

**Offshore funds are “tax neutral”.** Tax neutrality essentially means that the country where the fund is

formed, such as the Cayman Islands, does not impose its own duplicative layer of taxes on the fund. However, that does not mean that investors in tax neutral funds registered in offshore jurisdictions such as the Cayman Islands do not pay taxes - see the table below.

Tax neutral status is not unique to offshore funds. There are tax neutral fund categories in the UK and the USA, for example. What sets offshore funds - and particularly, offshore alternative funds - apart is the combination of tax neutrality, investment flexibility and sophistication allowed by offshore alternative fund structures. This is what makes offshore alternative funds so attractive to sophisticated investors.

As funds are often set up as a company or a partnership, those companies and partnerships can be subject to a separate tax charge in the place where they are formed. This means that investors could effectively (and unfairly) be taxed twice on the same income and capital gains. Such double taxation would render most funds uneconomic and defeat their purpose of assisting investors. Tax neutral funds provide an answer to this problem by removing this unfair “Layer 2” of tax (see the table below).

Tax neutrality in the jurisdiction where the fund is established - whether onshore or offshore - ensures that such duplication of taxation does not occur, preserving the attributes that an investor would have if investing directly in the underlying assets rather than through an alternative fund. A fund should be seen as

**Table: Why any fund should be tax neutral - the three layers of tax**

Investment through any alternative fund or other collective investment scheme adds a potential layer of tax over and above that which would be payable were the investors to own the underlying assets themselves. Ideally, alternative funds will be established with tax neutral status to prevent “Layer 2” tax being applied to the fund in addition to the taxes incurred (i) by the investors at “Layer 1” and (ii) on the investments at “Layer 3”, as illustrated in the table.

Layer of tax	Description	Comment
Layer 1 - Investors	Tax in investors’ own jurisdictions on investment income and realised capital gains, either as these arise to the fund or when investors receive proceeds from their interests in the fund.	The investors do not cease to be liable to domestic tax, even if they invest in an offshore fund. Offshore fund investors are visible to their tax authorities, which automatically receive information on their holdings.
Layer 2 - Fund	Tax in the jurisdiction where the fund is registered on the fund’s investment income and realised capital gains.	This would be an additional tax charge to be borne by the investors as it arises in respect of the same amounts as in Layer 1 and Layer 3. Onshore, as well as offshore, tax neutral funds are not taxed at this level.
Layer 3 - Investments	Tax in the jurisdiction where the fund invests on income and realised capital gains from the fund’s investments, e.g. on an equity stake that the fund has taken in a company or bonds that the fund holds.	Some jurisdictions charge tax on non-resident investors, unless they benefit from a double tax treaty or other relief. Offshore tax neutral funds are not exempt from this layer.

an aggregation of capital rather than a discrete taxable entity and such characterisation underpins many of the rules allowing exemption for funds in general.

**Offshore funds are transparent.** As regulation has evolved, particularly since the global financial crisis of 2008, the scope of “know your customer” (KYC) rules and standards has been expanded. Today, the identity of investors in Cayman funds and other offshore funds is reported to international tax authorities such as the IRS and HMRC. As a matter of US and Cayman law implementing FATCA, the alternative fund must register and provide this data. If it does not, it will face penalties but also in practice will not be able to trade with market counterparties (who are required to confirm the FATCA compliance of firms or funds they deal with). Ultimately, funds will likely expel investors who refuse to disclose sufficient information about their identity.

**Offshore funds are designed for sophisticated investors.** Offshore alternative funds are primarily designed as investment products for sophisticated investors. Such sophisticated investors usually employ experienced internal teams, or external consultants, who know how best to navigate the more flexible environment that offshore alternative funds operate in. Simply put, managers of offshore alternative funds face fewer restrictions - for instance, in their ability to leverage investments with borrowed money, to hedge their positions by going ‘short’ as well as ‘long’, or to impose restrictions on withdrawals (redemptions) - than managers of onshore funds authorised to raise money from retail investors. Some onshore fund locations, including Ireland and Luxembourg, do have fund regimes with similar flexibility aimed at certain types of sophisticated investors, but the Cayman Islands remains the leading alternative fund jurisdiction because a Cayman Islands alternative fund is what US sophisticated investors in particular expect to invest in.

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## FAQs

### **Are the identities of investors in offshore funds hidden from the authorities?**

The identities of offshore fund managers and investors in over 50 major jurisdictions (including the US and EU) are being fully and automatically disclosed to tax authorities worldwide under the US FATCA legislation, which came into operation in 2014, and the OECD’s Common Reporting Standard (CRS), which is being adopted from 1 January 2016. Under both FATCA and

the CRS, details of individuals who are US citizens or residents of participating jurisdictions will be reported in respect of each year to the relevant jurisdiction’s tax authority by the financial institution with which they hold accounts and exchanged on an automatic basis with the individuals’ own tax authority. These reporting regimes will affect individuals who invest directly in alternative funds or indirectly via private banks, funds of funds or passive investment companies.

### **Why are funds registered in offshore jurisdictions?**

The investment fund management industry is global in terms of the location of investors, the fund management team and the portfolio investments. Consequently, the challenge for fund managers is how and where to create alternative fund structures which are able to accommodate in a cost efficient way investors from all over the world within the complex parameters of existing tax and securities laws that apply to those investors, the management team and the business or investment activities, in their multiple home jurisdictions. Tax neutral jurisdictions help provide the solution to that challenge. Offshore jurisdictions such as the Cayman Islands are popular because they provide alternative funds aimed at sophisticated investors’ greater flexibility in terms of investment strategy than many onshore centres such as the UK and the US. They are also capable of better dealing with a broad range of international investors and their needs. Indeed, sophisticated investors expect professional and responsive procedures and simplicity when establishing alternative funds. Further benefits include the expertise and concentration of fund servicing businesses, the relatively low cost of establishing and managing such funds, and client demand for simple and flexible collective investment structures, which only certain jurisdictions (such as the Cayman Islands) allow.

### **Are offshore funds tax-free?**

A wide range of international initiatives has emerged in recent years, including the OECD’s Base Erosion and Profit Shifting (BEPS) project, which together are designed to address deficiencies in the international taxation system and create a fair tax environment that encourages cross-border trade and investment. But the surrounding public discussion, often by addressing complex issues in an overly simplistic manner, has at times conflated legitimate arrangements that have wide public benefit with those that rely on evasion or aggressive tax avoidance. In this context, the charge is levelled at the fund management industry that alternative funds are designed to avoid tax, and that is why alternative funds are often registered in tax neutral offshore jurisdictions. The charge is misconceived.

Alternative funds, being collective investment schemes, are not designed or promoted as vehicles for tax avoidance. In any case, the majority of alternative fund investors are sophisticated investors that are not always liable to tax in their own jurisdictions on their investment income and gains, and would be entitled to tax treaty benefits in their own right if they invested directly in the underlying investments of the alternative fund. Taxable investors in such alternative funds remain liable in their jurisdictions for any income or capital gains tax (Layer 1 tax) related to the profits generated by the underlying instruments in an alternative fund established in a tax neutral jurisdiction.

### Do onshore economies such as the US and UK miss out on tax because of offshore funds?

As stated above, investors in offshore funds are not hidden from the authorities. Assuming they are not tax exempt in their home jurisdictions, the investors will pay Level 1 tax on their income and gains in the usual way. But there is a further benefit to onshore economies. If a Level 2 tax were imposed on an offshore alternative fund by the jurisdiction (such as the Cayman Islands, Bermuda, BVI and Jersey), this would for most investors be an additional charge on their investment - albeit one that may be offset to some extent by a reduction in their Level 1 domestic tax liability. The effect would be to transfer part of the investor's Level 1 tax liability from the onshore jurisdiction to the offshore jurisdiction while increasing the overall burden of taxation for the investor.

### What is a tax neutral fund?

All collective investment schemes (such as mutual funds, exchange traded funds, hedge funds and private equity funds) exist to receive and pool investment monies from a range of investors and to deploy that capital in order to generate investment returns, while providing a wider spread of opportunity and risk than those investors might obtain individually. The fund is designed to preserve so far as possible the attributes that an investor would have if investing directly in assets such as shares and bonds rather than through the use of a fund. This includes taxation: if a duplicative level of tax (i.e. Layer 2 tax) were imposed, it would penalise collective or pooled investment over individual investment. It follows that "double non-taxation" of investments and investors is not an aim of collective investment schemes but rather to achieve tax neutrality as far as possible for a diverse investor base<sup>1</sup>. A tax

neutral regime is one where tax treatment does not influence investors' choices between investing directly or through a fund in the same underlying investments. In the vast majority of jurisdictions, funds that are established there have statutory tax exemptions. In the UK, this is limited to regulated funds. In the UK, open-ended investment companies (OEICs), authorised unit trusts and listed investment trusts are exempt from tax on their capital gains and, although these funds are not specifically exempt from tax on their income, it is effectively non-taxable in most such funds.

## Appendix

Alternative investment funds are established in many jurisdictions around the world, though the jurisdiction with the largest number of alternative funds is the Cayman Islands. Other offshore alternative investment fund domicile jurisdictions include the British Virgin Islands, Bermuda, Jersey and Guernsey. Ireland, Luxembourg and Malta are examples of onshore jurisdictions which offer equivalent regimes. In particular, all have implemented FATCA and committed to implement CRS, are rated compliant or largely compliant after Phase 1 and Phase 2 Global Forum Reviews, and are members of the Financial Action Task Force (FATF) or of regional bodies which are associate members of FATF. The comments made below in relation to the Cayman Islands apply broadly to these other jurisdictions as well:

- The Cayman Islands is a compliant financial services centre, which was removed from the OECD's "tax haven" blacklist in 2000<sup>2</sup>. The defining attribute of a tax haven is not whether it has a nil or low tax rate, but whether it provides transparency and cooperates with the tax authorities of other jurisdictions to counter any attempted tax evasion.
- The Cayman Islands government and its main regulator, the Cayman Islands Monetary Authority, have worked continuously with governments and international authorities over many years to ensure that the Cayman Islands is trusted as a well-regulated, cooperative and transparent jurisdiction. The Cayman Islands was an early introducer of comprehensive and strict anti-money laundering laws and KYC rules and regulations,

1 - This principle has been recognised by the OECD: BEPS, section 6 - Preventing the granting of treaty benefits in inappropriate circumstances (OECD). As regards the broader question of the treaty entitlement of non-publicly marketed funds, the OECD recognises the economic importance of these funds and the need to ensure that treaty benefits be granted where appropriate. The new treaty provision on transparent entities that is included in Part 2 of the Report on Action 2 (Neutralising the Effects of Hybrid Mismatch Arrangements, OECD, 2015) will be beneficial for such funds that are treated as fiscally transparent.

2 - According to a report by the US Congressional Research Service – Tax Havens: International Avoidance and Evasion (15 January 2015) - "The OECD initially examined 47 jurisdictions and identified a number as not meeting the criteria for a tax haven; it also initially excluded six countries with advance agreements to share information that includes [Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius, and San Marino] ... The 2000 OECD blacklist included 35 countries; this list did not include the six countries eliminated due to advance agreement."

which are at least equivalent to those of established OECD member states.

- The Phase 2 Peer Review Report on the Cayman Islands issued by the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes<sup>3</sup> on 11 April 2013 noted that the Cayman Islands had rapidly developed a network of 30 agreements for the exchange of information and that in terms of availability, access and exchange of information, the jurisdiction was either compliant or largely compliant (Phase 1 and Phase 2 Reviews - page 4). This is the same rating as given to the UK and the US. The report concluded that “the Cayman Islands has both the appropriate organisational processes and adequate resources in place to ensure that exchange of information takes place in an efficient manner and that timely responses are received”.
- The Cayman Islands is also committed to the various initiatives for the automatic exchange of tax information. It has implemented the US FATCA regime so that Cayman Islands financial institutions are obliged to report through the Cayman Tax Information Authority details of financial accounts held by US citizens and residents<sup>4</sup>. It has also implemented a similar regime relating to UK residents.
- The Cayman Islands is one of more than 90 jurisdictions that have committed to implement CRS on reporting and due diligence for financial account information and one of the over 50 jurisdictions (‘early adopters’) that have indicated their intention to introduce CRS due diligence from 1 January 2016 and reporting from September 2017. Under CRS, Cayman Islands financial institutions will be obliged to report through the Cayman Tax Information Authority details of financial accounts held by residents of the jurisdictions involved.
- Ultimately under FATCA, funds will likely have to expel investors who refuse to disclose sufficient information about their identity and some funds have begun that process. It is becoming clear that alternative funds would rather hand back money to an investor than fall foul of FATCA and the tax authorities.
- To date, Cayman Islands funds and other financial

institutions are by far the largest category registering under FATCA (the UK is the next largest).

Decades of experience and extensive due diligence have shown investors, fund managers, counterparties, regulators and international authorities the benefits of doing business through offshore fund jurisdictions such as the Cayman Islands. For example, the Cayman Islands has the following attributes:

- An English-based legal system, established judiciary, and absence of political or sovereign concerns.
- Well recognised legal concepts (including limited liability and separate corporate personality) underpinning the corporate, partnership and trust vehicles used as collective investment schemes, as well as the principles governing lending and granting security over assets, all of which have been tried and tested and found to be robust during the recent global financial crisis.
- The Cayman Islands is a well-known and trusted centre of excellence for its established and experienced financial services sector and professional service providers. That is a feature that grows on itself and having financial institutions, sophisticated investors, rating agencies and professional firms elsewhere used to and comfortable dealing with counterparts in the Cayman Islands may have become as big a reason as any for the use of Cayman Islands vehicles in many cases. There is a strong philosophy of government and industry cooperation and consultation. Indeed, a number of members of government are experienced finance experts who previously worked in the alternative fund industry.
- Professional and responsive procedures in place to establish Cayman Islands alternative fund vehicles.
- The Cayman Islands authorities are working hard with EU regulators to ensure that Cayman alternative funds qualify for the third country marketing passport under AIFMD.
- The Cayman alternative investment fund industry supports and encourages good corporate governance for its funds, including the extensive use of independent directors and administrators.

3 - The Global Forum has 126 member countries. The Cayman Islands sits on its 19 member Steering Group and 30 member Peer Review Group.

4 - As of May 2015, more than 30,000 Cayman financial institutions are registered for FATCA through the US Internal Revenue Service FATCA Portal, the greatest number for any jurisdiction. The jurisdiction with the next highest number of registrations is the UK, with in excess of 23,000 registered financial institutions.