

## INVESTING IN OFFSHORE HEDGE FUNDS – TAXATION ISSUES

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Offshore hedge funds are corporations that redeem shares at their net asset value. These entities are “passive foreign investment companies” (or PFICs) for U.S. tax purposes. Profits are “credited” net of all expenses – expenses that would otherwise be caught by the 2% and 3% limitations are deductible against any earnings, thereby reducing taxable income dollar for dollar and creating a tax liability only on net profits realized. Taxpayers should consider a number of factors when deciding whether to invest in a domestic onshore entity or an offshore vehicle that is classified as a corporation for U.S. federal income tax purposes. Most managers set up both a domestic and an offshore fund, with the conventional wisdom being that U.S. taxable investors invest in the domestic fund while tax-exempts and foreigners invest in the foreign one. However, taxable U.S. investors may want to think twice about this. A February 2004 article in the *Journal of Taxation of Investments* entitled “Tax Planning for Offshore Hedge Funds – The Potential Benefits of Investing in a PFIC” (written by Philip Gross of Kleinberg, Kaplan, Wolff, & Cohen, P.C. and available at [www.twenty-first.com/articles/gross\\_phil.htm](http://www.twenty-first.com/articles/gross_phil.htm)) aptly points out some intriguing benefits – especially the possibility of dramatically lowering state and local taxes – that could far outweigh the negative aspects of investing in the offshore entity.

For U.S. taxpayers, the argument against offshore investing stems from the PFIC rules (Internal Revenue Code Sections 1291-1298). These rules undermine the benefits of deferral and eliminate the conversion of income to long-term gain with offshore investment vehicles. The Government taxes all offshore profits at the highest rate *and* imposes on individuals a punitive (4% as of June 2004), non-deductible interest charge on taxes owed on any deferred income once the shares are distributed or sold. These two steps effectively put a cost on deferring tax at 4% after-tax. So if deferral were the only benefit associated with PFICs, then PFIC fund managers would need to compound returns at a rate higher than 4% after tax. Because of the PFIC rules, the offshore fund throws off only ordinary income – in fact, it will actually convert long-term gains (or dividends) that would have been taxed at 15% in the onshore fund into ordinary income taxed at 35%. So investors should consider the nature of expected returns. Convertible arbitrage that throws off no long-term gains (or qualified dividend income) would be least affected, whereas a hedge fund dedicated to long-term positions may be most affected by this conversion to ordinary income.

For U.S. taxpayers in many circumstances, however, PFICs offer benefits that more than counterbalance their drawbacks. A PFIC, if profitable, will have deferred income allocated to prior years. When its profitable shares are sold or distributed, the PFIC’s investors will incur both ordinary income tax and interest charges at the federal level. As Gross points out, the tax and interest are added to an investor’s current federal tax liability – they are not included as part of federal taxable income. But most states base their tax specifically on federal taxable income. We are advised that these rules could mean that prior years’ income should not be picked up in investors’ state and local taxes. This can create substantial savings in such high-tax states as Massachusetts and New York.

Obviously, there are some very real potential benefits to investing in a PFIC instead of an onshore fund. The PFIC structure ensures that you only pay tax on “real” profits and may also allow you to save on state and local taxes. If investors choose PFICs, a major drawback is the penalty charge associated with the deferral. However, if the fund generates an after-tax return significantly higher than the carrying cost of the interest, it may be economically attractive to take this charge and defer taxes. When doing a break-even analysis of what this after-tax return might need to be, investors should incorporate the state and local benefits as well as the benefit of avoiding the limitation of deductions. In a high-tax state a much

lower return would be needed. Investors that cannot deduct their management fees will find an even lower threshold of returns necessary to make the PFIC attractive.

The Twenty-First Securities Web site provides a calculator (available at [www.twenty-first.com/calc/pfic\\_model.xls](http://www.twenty-first.com/calc/pfic_model.xls)) that will compute the returns necessary for an offshore investment to outweigh a domestic one. Please note that this article may have been rendered partly inaccurate by events that have occurred since publication.

As always, when purchasing a hedge fund, including hedge fund of funds, one should carefully review the fund's offering materials. Hedge funds and hedge fund of funds have a high degree of risk including, without limitation, that these funds typically employ leverage and other speculative investment practices. The ability to make withdrawals typically is very limited. Remember hedge funds, either onshore or offshore, are not subject to the same regulatory requirements as mutual funds.