Introduction

You can set up a fund in any country without visiting it and your hedge fund can bank anywhere in the world. The two best countries for startup hedge funds are the United States and the British Virgin Islands. However, though there is no one "best" place, with professional advice, you can find the country that most closely matches your objectives.

Master Feeder Hedge Funds

Confusing to some is the use of onshore and offshore funds in a master-feeder structure. Master-feeder structures are used worldwide by fund managers for various reasons. The master-feeder hedge fund structure allows the investment manager to manage money for different classes of investors. Feeder hedge funds invest fund assets in a master hedge fund that has the same investment strategy as the feeder hedge fund. A master-feeder hedge fund structure requires multiple entities and an investment manager.

U.S. Feeder Hedge Fund with Offshore Master Hedge Fund

If you are a U.S. based fund manager, consider setting up an offshore fund if you manage money for foreign and/or U.S. tax-exempt individuals and businesses. Under U.S. income tax laws, a tax-exempt organization (such as an ERISA plan, a foundation, or an endowment) engaging in an investment strategy that involves borrowing money is liable for a tax on "unrelated business taxable income" (UBTI), notwithstanding its tax-exempt status. The UBTI tax can be avoided by the tax-exempt entity by investing in offshore hedge funds.

The master feed hedge fund structure typically includes a U.S. limited partnership (unless multiple share classes are needed; in that case, the hedge fund is a limited liability company) as the U.S. feeder hedge fund for U.S. taxable investors and a foreign corporation as the offshore feeder hedge fund for foreign investors and U.S. tax-exempt investors. A master hedge fund is formed offshore as well. The master hedge fund, structured as an offshore corporation, should file a Form 8832 with the
Internal Revenue Service (e.g., a check-the-box election allowing the master hedge fund to be treated as partnership for U.S. tax purposes), before engaging in trading activity on behalf of the feeder hedge funds. No such election is filed for the offshore feeder hedge fund.

Some investment managers try to skip the offshore master fund to save money and attempt to use the offshore feeder hedge fund as the master hedge fund. However, if U.S. taxable investors invest in or effectively control the offshore hedge fund, complex U.S. tax rules applicable to controlled foreign corporations, foreign personal holding companies, or passive foreign investment companies (PFIC) become problematic.

Offshore Hedge Funds

U.S. based advisers with potential investors outside the United States and/or U.S. tax-exempt investors can setup offshore funds. Offshore funds allow these clients to avoid Unrelated Business Taxable Income (UBTI). Under U.S. laws, a tax-exempt investor (such as an IRA, an ERISA-type retirement plan, a foundation, or an endowment) is liable for 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 fund that trades on margin.

Is Running a Hedge Fund Profitable?

Yes. Hedge fund managers typically demand management fees of 1% to 2% of assets under management (AUM) as well as performance fees of 20% to 50% of net trading gains. Performance is calculated on a cumulative basis against a high-water mark so that performance fees are not paid out (or are reduced) until the losses are recouped. Some hedge funds limit the number of years of loss carry-forward for the purposes of calculating performance fees. This income can be substantial! If you had $2 million AUM and a 1% management fee and a 20% performance fee, you would have combined fee income of $140,000 from a $20,000 management fee ($2 million x 1%) and (assuming fund performance of 30%), performance fee income of $120,000 ($2 million AUM x 30% performance=$600,000 x 20%). If you had $5 million under management, you would have combined fee income of $350,000. If you had $1 billion AUM, you would have $50 million in combined fees, assuming fund performance of 20%.

Compensation Planning and Income Tax Deferral

An investment manager of the offshore fund should ensure that his contracts are prepared so as to allow deferral of management and performance and incentive fees. Through the use of properly prepared offering documents and the use of outside directors, an investment manager should be able to defer for income tax purposes substantial amounts of money (e.g., both the deferred fees and earnings on the fees compounded tax free in the fund).