

MARTIAL CAPITAL WHITEPAPER:  
**Investing Offshore:  
Advantages & Disadvantages**



“Offshore investing” is the stuff of novels and legend: its secrecy makes it seem mysterious, like some underground society; and the wizardly performance of some offshore funds makes it appear vaguely suspicious.

The truth is more prosaic. Investing offshore is nothing more than another way of investing, with advantages and disadvantages, like any other investment choice.

Before we begin, however, let us put a caveat right up front: the information in this White Paper might not apply to you, either because of special considerations with your own legal and tax situation, or because you live in or are taxed in a country that has unique rules, or for any number of other reasons. So please consult your legal and tax professional. By all means use the information on these pages as the starting point of your conversation, but at the end of the day, please follow their advice.

## **What does “Offshore” mean?**

Every investment vehicle – mutual fund, partnership, or hedge fund – is a legal entity that resides somewhere. By definition:

- ▶ A “domestic” or “onshore” fund or investment is an investment that is located – whose corporate entity or partnership is registered – in the country where you live.
- ▶ An “offshore” investment vehicle is located in a different country than the one where you live.

There is another, more informal definition of “offshore”: an investment entity that is located in a country that specializes in hosting “offshore” entities. Some of the best-known examples are Bermuda, the Cayman Islands, the Channel Islands, and Malta.

Why would someone want to locate a fund in Bermuda? To allow investors from all over the world to participate in the fund. The result is a vast array of some of the most compelling investment vehicles you’ll ever find located in these offshore jurisdictions. The amount of money invested in these ‘offshore’ funds is in the trillions of dollars.

Contrary to popular belief, Bermuda, the Cayman Islands, Malta, and other similar offshore locations impose tight rules on funds and their investors to comply with terrorism, money-laundering, and proceeds-of-crime prevention as well as know-your-client rules, but they do not impose taxes on funds located in their jurisdiction and they allow a wide variety of investment strategies, all of which is good for you, the investor.

## Why is Offshore Investing So Secretive?

It is completely legal for residents in all countries we know of to invest in offshore funds. What is not legal is for an offshore fund to directly market to the public in another country. This is because the securities regulators in the majority of industrialized countries require that a firm which “offers securities to the general public” be registered in that country.

“Offering” has a widely different meaning from one country to another. In general, however, it allows an offshore fund to talk to investment professionals in that country – bankers, brokers, lawyers, accountants – but not to investors directly. Thus offshore funds generally do not advertise or give interviews or speeches or issue press releases or do anything else that might make the securities regulator in a country feel the fund is “offering” its products to the “general public” of that country.

Offshore funds are secretive not because they have anything to hide. It’s not because anything they do is illegal. It’s because they’re trying to comply with local securities laws.

## Paying Taxes on Offshore Funds

In every jurisdiction we know of you must declare your ownership of offshore funds to your local tax authorities and you must pay taxes on their profits. However, most countries tax your offshore investments differently than they do a domestic fund. You should compare the way your offshore fund might be taxed versus how an identical local fund would be taxed in your own country. You might be surprised to discover there are considerable and completely legal tax advantages to investing offshore.

For example, in most countries when you invest in a domestic fund you must report and pay taxes on the realized profits within that fund each year, even if you don’t sell your units. Thus you must pay taxes each year on profits you have not, yourself, yet realized.

However, when you invest in an offshore fund you may only have to pay taxes on an imputed capital gain of perhaps 1% per year. You pay taxes on the rest of your capital gains only when you actually

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sell your units.

In some countries, you might not have to pay any taxes at all on the profits inside your offshore funds until you sell your units.

If your offshore investments are growing at an average of 20% per year, offshore funds might be considerably more advantageous to you than the 'pay-as-you-go' taxation method imposed on domestic funds because virtually all of your profits from off-shore funds are reinvested tax-deferred – until you ultimately sell them.

Check with your own tax experts and find out how you would be taxed if you bought shares in an offshore fund. You might be pleasantly surprised.

## Withholding and Reporting

If you buy a domestic fund, you will get all of the dividends and interest your fund earns without any withholding, but the fund will report your share of the gains and the income to your local tax authorities. That's why they ask for your tax ID number when you enroll in a domestic fund.

Offshore funds do not ask for your tax ID numbers because they do not report your gains or income to any tax authorities. On the other hand, many of the countries where an offshore fund might invest will withhold some portion, typically 30%, of the dividends and interest (but not on the gains from buying and selling) your offshore fund might earn.

If dividends or interest are a significant portion of the returns of an investment strategy you are attracted to, it might be more advantageous to invest in a domestic fund.

## Protection from Abuse and Fraud

Although most offshore jurisdictions have a first-class judicial system, it is likely to be in English, it will likely follow English common law, and the players will be strangers to you. Many people feel more comfortable knowing that if something goes wrong, they can sue for redress in their local courts in a language and legal system that is more comfortable for them. If this is an over-riding concern for you, then perhaps investing in domestic funds is more appropriate.

On the other hand, in Bermuda and the Cayman Islands you can appeal decisions to the Privy Council in London and for many, English common law is not only familiar but preferred.

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Many offshore jurisdictions require that the funds based in their country use third party administrators and custodians. This means that your money and assets are generally in the hands of third parties, not the investment manager. Compare that with the lack of protections built into domestic funds where, in many cases, the investment manager holds your money, invests it themselves, calculates the NAV, and does all the accounting themselves.

Some people, worried about theft and fraud, might feel more comfortable with having their money always in the hands of objective third parties; something that is more common in offshore funds than domestic funds.

## You Must Be an “Accredited” Investor

Regardless of whether you invest in domestic or offshore funds, you must be an accredited investor. The concept of an “accredited investor” is someone who has the sophistication to understand the risks they are undertaking in investing in a fund. All jurisdictions we know of both offshore and domestic have some minimum requirements to ensure that all its investors are “accredited”.

The determination of whether an investor meets the test is almost always made by the investor themselves. No jurisdiction we know requires a fund to make an independent check of an investor’s compliance with the accreditation test.

In some jurisdictions an investor can meet the test of accreditation by virtue of their education or experience. The theory is that a person with an MBA or a CFA or a CA, or someone who has 10 years of experience in the investment business probably has the knowledge to make their own investment decisions. Other jurisdictions have income or net worth tests.

- ▶ Bermuda-domiciled funds, for example, can only be sold to investors who have (a) USD 200,000 or equivalent in personal income in each of the two previous years or (b) a net worth of USD 1 million or equivalent or (c) “an individual who has such knowledge of, and experience in, financial and business matters as would enable him to properly evaluate the merits and risks of a prospective purchase of investments”
- ▶ US-domiciled funds that rely on a “3(c)7” exemption from registration can only be sold to investors with a net worth of at least USD 5 million or \$200,000 in personal income in each of the two previous years with a reasonable expectation of doing the same in the current year.
- ▶ Canadian-domiciled funds, Ontario in this case, define an accredited investor as someone with a net worth of CAD 1 million net of their house or CAD 200,000 in income for

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the past two years with a reasonable expectation of doing the same in the current year.

As you consider whether to invest offshore or domestically, you should consider whether you will meet the tests of “accredited investor”.

## Full Disclosure

Funds that are sold only to accredited or sophisticated investors have generally few laws about required disclosure. In the US, funds sold to accredited investors have no disclosure requirements at all. Canada and Bermuda-based funds require a prospectus that meets certain specific requirements. So it depends entirely on where you live whether a domestic fund is likely to give you more complete disclosure than an offshore fund.

Furthermore, some offshore jurisdictions, like Bermuda, require that funds based there be audited by reputable independent accounting firms. In the US and perhaps in your country, domestic funds do not need to be audited. Once again, it’s not necessarily the case that domestic funds are less risky than offshore funds.

## How do I find an Offshore or Domestic Fund?

Because funds that are marketed to accredited investors – both domestic and offshore – are prohibited from marketing directly to potential investors you will need to take the initiative yourself. Our advice is:

- ▶ Go to your tax and legal professionals and decide if offshore or domestic funds are most likely to meet your needs. Check out the tax treatment of each type and see if there are tax advantages to one or the other. Keep in mind that when you talk to a lawyer, everything you say will be under the seal of attorney-client privilege.
- ▶ Armed with tax and legal advice, consult with investment professionals familiar with the kind of vehicle seems right for you: domestic or offshore. There are off-shore experts in many investment and accounting firms, but often the most knowledgeable are (i) international tax partners at major law firms or (ii) private bankers.
  - ▶ Have them tell you about the historical returns of the fund. A fund should share that information with you. Make sure the numbers they give you are after fees and expenses. Have they been audited?
  - ▶ Have your professional ask about the drawdown history of the fund. What is the largest drawdown the fund has ever experienced? How

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long did it last? This information should be readily available.

- ▶ Have them ask about chain of custody of your money and assets (securities). Does it remain in third party hands? Who calculates the NAV? Third parties?
- ▶ Have your professional ask about procedures for redemption. Are there any lock-up periods? How often can you withdraw your money? Are there any exit fees? The ideal fund will have no lock-up period, will allow you to withdraw your money with reasonable frequency (monthly or more often) and with reasonable notice (a week or two) with no exit fees.

Why do we say “have your professional ask” about these items? Because funds are not allowed to market directly to you; it is against local securities laws for them to do so. They are only allowed to talk with professional intermediaries, unless you approach the funds yourself.

Approaching an offshore fund directly yourself is legal, and if you happen to travel abroad and meet with them, you will find them friendly and forthcoming with all the information you need to make an informed decision; they’ll even buy you lunch.