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Investment Funds
& Investment Management
Corporate & Securities
May 30, 2007

Waves of Change Hit Shores of Offshore "Tax Havens"

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Many fund managers establish investment funds in offshore "tax haven" jurisdictions to satisfy the tax efficiency requirements of their tax-exempt investors (i.e., non-profit entities such as foundations and pension funds). The use of offshore jurisdictions for the purpose of tax avoidance has been a great success for tax-exempt investors, much to the chagrin of the U.S. Congress, which recently estimated that more than $100 billion in tax revenue is lost each year due to investments in offshore funds.

Congress is currently contemplating restricting the ability of U.S. tax-exempt entities to generate tax-free income from investments in offshore funds. Specifically, Congress is scrutinizing the tax-exempt entities' use of offshore "blocker" corporations to avoid paying unrelated business taxable income ("UBTI"). Under current law, certain tax-exempt entities may avoid paying UBTI merely by investing through a company organized in an offshore jurisdiction.

The last time Congress passed significant legislation regarding offshore funds was in 1997, when it repealed the "Ten Commandments." As a result, offshore funds that trade for their own accounts are deemed not to be engaged in a U.S. trade or business even if the fund manager maintains its principal office in the U.S. However, Congress did not take action to restrict the ability of tax-exempt entities to take advantage of offshore jurisdictions, due in large part to the commitment of the U.S. to foster economic development in the Caribbean region. Whether or not the current Congress is fully committed to restricting the use of offshore jurisdictions remains to be seen. For now, it appears that offshore jurisdictions will continue to be attractive to U.S. fund managers and their clients.

Traditionally, offshore jurisdictions have been attractive to fund managers because the offshore jurisdictions typically subject the fund managers and their clients to a reduced regulatory regime and favorable tax treatment. However, based on recent developments, offshore jurisdictions appear to be at a crossroads. In an attempt to attract and retain fund managers from the U.S., the U.K., Japan, Switzerland and other "money

center" jurisdictions, offshore jurisdictions have had to satisfy the infrastructure demands of fund managers, address anti-money laundering and fraud considerations, and, at the same time, find ways to raise additional revenue to support the implementation of their policies, while still holding themselves out as "low tax" or "no tax" jurisdictions. In the last few months, we have seen a significant amount of new law being passed in offshore jurisdictions – some of which seek to raise revenue through additional filing fees and annual updating fees, while others seek to attract new fund managers by streamlining the organization process for new funds.

To help fund managers with offshore funds stay apprised of changes to the laws in these jurisdictions, we have summarized below recent developments in some of the more popular offshore jurisdictions.

Bermuda

Bermuda's House of Assembly has passed the Investment Funds Act 2006 ("IFA"), which replaces the Bermuda Monetary Authority (Collective Scheme Classification) Regulations 1998. The IFA will regulate "investment funds," which are broadly defined to include companies, unit trusts and partnerships organized in Bermuda that permit investors to redeem their rights or interests (i.e., open-ended investment funds). Under the IFA, three types of investment funds may be authorized: (i) an institutional fund (i.e., a fund only available to sophisticated or high-net-worth investors or a fund that requires each investor to invest at least $100,000 in the fund); (ii) an administered fund (i.e., a fund that uses a licensed administrator and requires investors to invest at least $50,000 in the fund or a fund that is listed on a recognized stock exchange); and (iii) a standard fund (i.e., a fund that does not qualify under either of the categories above).

An investment fund subject to the IFA may not operate in Bermuda unless it receives authorization from the Bermuda Monetary Authority (the "BMA") or qualifies for an exemption. To qualify for an exemption, the investment fund must meet the following criteria: (i) it is open only to qualified investors (based on income, net worth and level of investment sophistication); (ii) it is administered by an administrator recognized by the BMA; (iii) it appoints an auditor; and (iv) there is an officer, trustee or representative living in Bermuda with access to the fund's books and records. In addition, the BMA must deem the investment fund's operator (e.g., general partner of a limited partnership) and its service providers to be fit and proper. An exempted investment fund must file an annual notice stating that it remains qualified for the exemption and pay an annual fee.

Investment funds that are "private funds," or funds that do not allow more than 20 investors and are not advertised to the general public, are excluded from the IFA's regulation, provided that the BMA is promptly notified that the fund qualifies for an exclusion from the IFA's requirements.

British Virgin Islands

The British Virgin Islands have introduced a web-based information system called the Virtual Integrated Registry and Regulatory General Information Network ("VIRRGIN"). The Financial Services Commission of the British Virgin Islands launched phase one of the system at the end of 2006, which allows documents to be filed electronically with the Registry of Corporate Affairs twenty-four hours a day. Once the implementation of VIRRGIN is completed, which is expected to occur in 2007, users will be able to (i) search for public company records online, and (ii) electronically file their documents and electronically signed certificates, and receive electronically stamped/returned memoranda and articles of association from the system.

Cayman Islands

The Cayman Islands Monetary Authority ("CIMA") has amended the Cayman Islands Mutual Funds Law. Although no major change was made to the regulatory regime, the following changes should be noted:

- The CIMA instituted a new electronic reporting initiative that requires funds regulated under the Mutual Funds Law (2003 Revision, as amended) to file their audited annual reports electronically, preferably in a machine-readable, portable document format. The operator of a fund must complete and file a Key Data Elements ("KDE") Form, which requires basic information about the fund. The audited annual reports and the KDE Forms must be submitted to the CIMA through the fund's approved Cayman Islands audit firm. Fund managers should be aware that in many cases, this new requirement will add significant expense to the cost of the audit.

- A fund that is administered in the Cayman Islands, but not incorporated there, is no longer deemed to be conducting business in the Cayman Islands, as long as it does not offer investments to the general public in the Cayman Islands. For this purpose, the general public does not include high-net-worth or sophisticated investors, exempted companies, foreign registered companies, general partners of exempted limited partnerships or exempted trusts.

- Fund administrators are now required to satisfy themselves that each fund to which they provide administration services (i) uses a promoter that has a sound reputation, (ii) has someone with sufficient expertise and a sound reputation performing the fund's administration, (iii) conducts its business and offers securities in a proper manner, and (iv) is organized in a country approved by CIMA.

- The auditor of a fund or of a fund administrator must notify CIMA if the auditor believes that the fund or the fund administrator is (i) insolvent or nearly insolvent, (ii) conducts business or voluntarily winds up in a manner prejudicial to its investors and creditors, (iii) keeps inadequate accounting records, (iv) conducts business in a fraudulent or criminal manner, or (v) is not in compliance with applicable law.

- The minimum subscription for funds wishing to register under Section 4(3) of the Cayman Islands Mutual Funds Law has been raised from $50,000 to approximately $100,000.

Ireland

Ireland has revised its fund authorization process for qualifying investor funds by dispensing with a detailed review by the Irish Financial Regulator. Ireland will now allow qualifying funds to be approved within twenty-four hours of filing the required documentation. In order to qualify for the "fast track" filing process, (i) the fund must have a minimum subscription amount of €250,000 and (ii) the promoter, fund managers and directors must have been previously approved by the Irish Financial Regulator.

Guernsey

The Guernsey Financial Services Commission ("FSC") has streamlined its consent process for closed-end funds. The consent process, which previously could take up to several weeks, can now be completed within three days if the required fee and the following documents are submitted to the FSC:

- Certified final copy of the offering document or the equivalent, including the subscription agreement or the equivalent;

- Certified copies of the constitutive documents (e.g., memorandum and articles or limited partnership agreement);
- Certified final copies of all material agreements (e.g., the investment management agreement);
- A certificate from the fund's administrator certifying that the fund's promoter and the fund's associated parties are fit and proper, that the fund will not offer securities directly to the public in Guernsey, and that the offering document contains the required disclaimers; and
- Forms GFA and APC, Forms PQ to be completed by the directors of the fund, and Forms PQ for any controllers, directors or senior management of the promoter.

Jersey

There have been three significant developments in 2007 relevant to Jersey's funds industry:

- The Dutch Financial Markets Authority has determined that Jersey funds may be listed on the Euronext exchange without a license in the Netherlands.
- The Jersey Financial Services Commission ("JFSC") has introduced the Listed Fund Guide, which ensures that closed-end investment funds may be eligible for a streamlined 72-hour approval process. In order to qualify for the 72-hour approval process, the fund must: (i) be listed on a recognized stock exchange or market; (ii) be incorporated as a Jersey closed-end company; (iii) have a majority of independent directors on the board; (iv) have a fund manager that has suitable experience and is regulated in its own jurisdiction; (v) satisfy the JFSC's corporate governance principles; and (vi) meet other requirements set forth under the "Expert Fund" regime.
- The States of Jersey have amended the Island's Income Tax Law to ensure that Jersey companies are treated as non-residents for tax purposes, provided that certain conditions are satisfied.

Luxembourg

In February 2007, Luxembourg enacted the specialized investment fund law that replaces its 1991 institutional investor fund law. The new law provides for light regulation of funds created under the new law ("Specialized Investment Funds" or "SIFs") and emphasizes self-regulation by the fund manager. The main features of the new law are as follows:

- Investments in a SIF may be offered to an institutional investor, professional investor, or any other investor who declares in writing that he is an informed investor and either (i) invests at least €125,000 or (ii) has a bank or finance professional certify that he has the experience and knowledge to adequately understand the investment in the SIF.
- The fund manager must be organized in Luxembourg; the custodian must have its registered office in Luxembourg; the SIF must be audited by an auditor who is authorized in Luxembourg; and the SIF must have €1,250,000 of assets under management within 12 months of the Commission de Surveillance du Secteur Financier's ("CSSF") authorization. The CSSF will not perform checks on the status or financial condition of the fund manager.

- No prior authorization from the CSSF is required to set up a SIF. However, the SIF's constitutional documents, choice of custodian and information regarding its directors and officers must be provided to the CSSF within one month of the SIF's formation. The SIF law does not require the offering documents to contain certain minimum information.

- SIFs are also not required to provide investors with semi-annual reports, but must provide investors with an annual report.

- The terms and conditions of a subscription or redemption of interests are subject only to the constitutional documents.

- SIFs are not subject to any investment or leverage restrictions.

Conclusion

The multi-headed Hydra facing offshore jurisdictions includes the need (i) to constantly innovate to meet the demands of fund managers and their clients, while keeping taxes and related costs at a minimum, and (ii) to build the regulatory and market infrastructure necessary to withstand the criticism of money-center jurisdictions that will point to lax regulatory standards as further reason to disallow the tax benefits of doing business from offshore jurisdictions. How these offshore jurisdictions handle these issues could have a profound impact on fund managers and their clients. We will continue to monitor legislative and regulatory initiatives in both money-center and offshore jurisdictions, and keep you informed of new developments that may affect your business.

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