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Special Considerations in Forming Private Real Estate Funds

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Introduction

While closed-end real estate private equity funds (Real Estate Funds) are generally structured similarly to traditional private equity funds, there are several key differences. First, there are sometimes significant regulatory differences under the Investment Advisers Act, the Investment Company Act and similar state laws, stemming from the unique nature of Real Estate Fund investments. Second, Real Estate Fund managers often have different potential conflicts of interest than private equity fund managers, including because Real Estate Fund managers often seek to retain their affiliates to provide various specialized services to the fund for a fee. Third, fund economics in Real Estate Funds can also be relatively unique, particularly where the Real Estate Fund is receiving income from operations. Finally, Real Estate Funds face special tax considerations that other private funds do not. This practice note will touch on each of these topics, identifying some key differences and providing guidance for how to analyze and address them.

Overview: Industry Overview and Types of Real Estate Funds

Industry Overview

Although Real Estate Funds make up only a portion of overall private closed-end funds, they nonetheless are a significant asset class in their own right. For example, according to Prequin's Historical Private Equity Real Estate Fundraising Statistics, in 2015 traditional private equity fund capital raising comprised approximately 50% and Real Estate Fund capital raising comprised approximately 15% of all private closed-end fund capital raising. This 2015 Real Estate Fund capital raising resulted from 123 Real Estate Funds that closed on a total of $77.9 billion of capital raised.

Regulatory History and SEC Focus

Many private fund managers, including Real Estate Fund managers, registered with the Securities and Exchange Commission (SEC) as investment advisers for the first time in 2012 as a result of the changes in applicable law brought about by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act.

Focus on Real Estate Funds

For the first few years after that, the SEC staff focused on learning more about hedge funds and private equity funds. However, the SEC staff now appears to have started to focus on Real Estate Funds as well. For example, in January 2015, Igor Rozenbilt, co-head of the SEC's Private Fund Unit, reported at the Global Private Equity Conference in New York that the SEC staff intended to turn its focus to "adjacent illiquid asset classes" (e.g., Real Estate Funds). Likewise, in May 2015, Marc Wyatt, the then acting director of the SEC's Office of Compliance Inspections and Examinations, announced at the Private Equity International Private Fund Compliance Forum in New York that there is room for improvement in the practices of Real Estate Fund advisers. Specifically, he said that the SEC's Private Funds Unit was interested in private Real Estate Fund advisers using an opportunistic and value-add strategy (see descriptions of those strategies below), because those managers are often more vertically integrated than traditional private equity managers.

Special Role of Real Estate Fund Counsel

Because many, if not most, Real Estate Fund managers come from a real estate rather than securities background, it can be particularly difficult for them to adjust to the compliance obligations that come with registration under the securities laws. For that reason, it is potentially more important than with other fund manager clients that Real Estate Fund counsel help guide their clients through the applicable regulatory requirements and process.

Real Estate Fund Strategies

In order to understand and advise Real Estate Funds, it is important to be familiar with the kinds of strategies that they employ. Typical Real Estate Fund strategies include:

Strategies Based on Risk Level

- **Core.** This is a lower risk strategy that generally focuses on fully-leased multi-tenant properties in strong markets. This strategy involves lower leverage and generally has steady cash flows.
- **Core-Plus.** This is a moderate risk strategy that is similar to the core strategy but with some additional element of risk, such as imminent large lease expiration.
- **Value add.** This is a medium risk strategy that generally involves the purchase of property or other real estate assets that require some (but not a high) level of improvement.
- **Opportunistic.** This is a higher risk strategy that generally involves the purchase of property or other real estate assets that require a high level of improvement or investment.

Strategies Based on Real Estate Type

- **Undeveloped real estate.** These funds purchase real estate for development or entitlement. The fund adds value and seeks a return based on the manager's expertise in obtaining entitlements and completing development.
- **Distressed real estate.** This strategy involves investment in distressed real estate assets at a low price, with plans to revitalize the asset and sell it at a higher price.
- **Real estate asset classes.** Real Estate Funds may also focus on different types of real estate, such as agricultural, commercial, hospitality, industrial, multifamily residential, single family residential, and retail.
- **Geography.** Likewise, Real Estate Funds may focus on different geographic locations, such as certain U.S. regions or non-U.S. regions.

Regulatory Considerations

All private fund managers need to consider regulatory requirements that may apply to them, including without limitation the Investment Advisers Act of 1940, as amended (Advisers Act), the Investment Company Act of 1940, as amended (Investment Company Act) and related state laws. Real estate fund managers, unlike their private equity fund counterparts, often invest in assets that are not securities, which in many cases lead to a very different analysis of the regulatory regime applicable to them.

Investment Advisers Act

The Advisers Act defines an "investment adviser" as any person who, for compensation, is engaged in the business of advising others or issuing reports or analyses regarding securities. Advisers Act, § 202(a)(11). Persons who fall within the definition of investment adviser are required to register with the SEC or, if applicable, with the states in which they do business, unless they qualify for exemptions from registration. In general, (1) advisers that manage over $100 million in regulatory assets under management (RAUM) are subject to federal registration with the SEC, unless an exemption applies, and (2) advisers that manage less than $100 Million RAUM must register in the State in which they do business, unless a State exemption applies. There is also an exemption from registration for managers that advise less than $150 million of RAUM and only advise private funds. Therefore, in order to confirm whether or in what jurisdiction a Real Estate Fund manager should register as an investment adviser, it is a key to confirm the amount of its RAUM.

Applicable Definition of "Security"

A threshold question for Real Estate Fund managers is whether the funds that they advise invest in securities. The Adviser's Act defines a security as:

> "any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ''security'', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guaranty of, or warrant or right to subscribe to or purchase any of the foregoing". Advisers Act, §202(a)(18).

Howey Test

While the Advisers Act definition of securities is not exactly the same as the definition under the Securities Act of 1933, as amended (1933 Act) or the Securities Exchange Act of 1934, as amended, case law related to those definitions is relevant to the definition of security under the Advisers Act. The leading case regarding whether real estate interests are securities is SEC v. W.J. Howey. In that case, investors received an ownership interest in individual rows of trees in a citrus grove development, coupled with a contract for cultivating and marketing the trees, and in turn were to receive a share of the proceeds from such land. The United States Supreme Court held that this arrangement constituted an investment in a security under the 1933 Act because (1) there was an investment of money in a common enterprise with others; (2) there was an expectation of profit from the investment and (3) the outcome of the investment depended solely on the efforts of others. SEC v. W.J. Howey, 328 U.S. 293 (1946).

Application of Law: When Real Estate Interests are "Securities" under the Advisers Act

Many real estate funds hold only (or primarily) two types of assets: (1) membership interests in single member limited liability companies that in turn own fee title to real estate and (2) either general partner or limited partner interests in limited partnerships (or comparable interests in limited liability companies) that own fee title to real estate. The definition of security under the Advisers Act is not helpful for determining whether these interests are securities. However, applying the Howey test (and related circuit court precedent, as applicable), most practitioners take the position that (1) membership interests in single member limited liability companies that own fee title to real estate are almost certainly not securities; (2) general partner (or managing member) interests in limited partnerships (or limited liability companies) that own fee title to real estate generally, but not always, are not securities; and (3) limited partner (or non-managing member) interests in limited partnerships (or limited liability companies) generally, but not always, are securities.

The Definition of a Securities Portfolio for Purposes of RAUM Calculation

RAUM is defined as the securities portfolios over which an investment adviser "provides continuous and regular supervisory or management services". 15 U.S.C. § 80b–3a (a)(3) (2015); SEC Form ADV: Instructions for Part 1A, at 6–7 (2011) https://www.sec.gov/rules/final/2011/ia-3221-appb.pdf. Though the term "securities portfolio" is not defined within the Advisers Act itself, Part 1A of Form ADV (Instructions) provides detail regarding what constitutes a securities portfolio. Specifically, the Instructions state that an asset or account might qualify as a securities portfolio in one of two ways, depending on whether or not the adviser manages private funds.

Non-private Funds

First, for assets managed outside of private funds (as defined below), if more than 50% of the total value of an account consists of securities, the account is considered a securities portfolio. In that case, the total value of the account, including the value of both security and non-security assets, is included in the investment adviser's RAUM calculation. Alternatively, if less than 50% of the total value of an account consists of securities, the account is not considered a securities portfolio, and none of its value is included in calculating the investment adviser's RAUM. 15 U.S.C. § 80b–3a (a)(3) (2015); SEC Form ADV: Instructions for Part 1A, at 6–7 (2011) https://www.sec.gov/rules/final/2011/ia-3221-appb.pdf.

Private Funds

All of the assets of private funds are considered securities portfolios. "Private funds" are those that would otherwise be required to register as investment companies under the Investment Company Act but for reliance on the Section 3(c)(1) and/or 3(c)(7) exceptions

from the definition of "investment company" under the Investment Company Act (3(c)(1) and/or 3(c)(7) Exceptions). 15 U.S.C.A. § 202 (a)(29) (2015). These types of funds cannot rely on the 50% test described above, but instead all their security and non-security assets are counted toward the investment adviser's RAUM. 15 U.S.C.A. § 80a–3; SEC Form ADV, supra, at 7. https://www.sec.gov/rules/final/2011/ia-3221-appb.pdf.

Whether a Real Estate Fund Should Be Considered a Securities Portfolio

Real estate funds that rely on the 3(c)(1) and/or 3(c)(7) Exceptions are private funds, which means that all their assets are considered securities portfolios for purposes of RAUM calculation. 15 U.S.C.A. § 80a–3. Real Estate Funds that instead rely on the Section 3(c)(5)(C) exception from the definition of the term investment company under the Company Act (3(c)(5)(C) Exception), however, are not private funds for this purpose and may use the 50% test described above. Thus, if less than 50% of the value of a fund relying on the 3(c)(5)(C) Exception are securities, then the manager would not be required to count any of the assets of the fund toward its RAUM. Please see below for a discussion of the 3(c)(5)(C) Exception.

Investment Company Act

Section 3(a)(1)(A) of the Investment Company Act defines an investment company, as "any issuer which . . . is or holds itself out as being engaged primarily, or proposes to engage primarily in the business of investing, reinvesting, or trading in securities." Section 3(a)(1)(C) of the Investment Company Act defines an investment company, as any issuer that (among other things) holds more than 40% of its assets (other than cash and government securities) in investment securities. A common denominator in both of these definitions is the investment in securities. If a Real Estate Fund is not investing in any securities, then it will not need to rely on an exception from registration under the Investment Company Act. This is because in that case it will not meet either definition of an investment company because it will not be in the business of investing in securities. Where the Real Estate Fund invests in a mix of real estate and securities (or if it invests entirely in securities), it will need to find an applicable exception from the definition of investment company in order to avoid the need to register as an investment company.

Definition of "Security"

The definition of security under the Investment Company Act, 15 U.S.C.A. § 80a–2(a)(36), is identical to the definition under the Advisers Act.

Definition of "Investment Security"

"Investment securities" are defined as all securities except (1) government securities, (2) securities issued by employees' security companies, and (3) securities issued by majority-owned subsidiaries of the owner that (x) are not investment companies and (y) are not relying on the 3(c)(1) and/or 3(c)(7) Exceptions. 15 U.S.C.A. § 80a–3(a)(2).

"Holding Out"

Note, however, that under Section 3(a)(1)(A) of the Investment Company Act, an issuer that holds itself out as being engaged primarily in the business of investing, reinvesting, or trading in securities is considered an investment company. Thus, a Real Estate Fund that does not want to classified as an investment company should avoid making statements about its business that suggest that the fund is in the business of investing, reinvesting, or trading in securities.

The 3(c)(5)(C) Exception

In some cases, where a Real Estate Fund is investing in securities (and therefore needs to find an exclusion from registration) but does not want to be bound by the requirements of the Section 3(c)(1) (100 investor limit) or Section 3(c)(7) (investors must be qualified purchasers) exceptions from the definition of investment company, it may be able to rely on the 3(c)(5)(C) Exception. This exclusion may apply where the Real Estate Fund is "not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates…" and is "primarily engaged in … purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." To satisfy the primarily engaged requirement of the 3(c)(5)(C) Exception, the Real Estate Fund (1) must invest at least 80% of its assets as follows: (A) not less than 55% thereof in Qualifying Interests; plus (B) up to 25% thereof in "real estate related assets"; and (2) may invest up to 20% of its assets without restriction. 15 U.S.C.A. § 80a–3(c)(5).

"Qualifying Interests"

In general, a Qualifying Interest must represent an actual interest in real estate or be a loan or lien actually backed by real estate. Among the types of investments that the SEC staff has found to be Qualifying Interests are fee interests, installment land contracts, leaseholds, mortgage loans, deeds of trust, and other interests secured by real estate, condominiums, and cooperative housing loans, real estate and portfolios consisting of several different types of qualifying interests. See, Investment Company Determination Under the 1940 Act: Exemptions and Exceptions, by Robert H. Rosenblum, published by the ABA Section of Business Law, §15.4.

"Real Estate Related Assets"

Although the SEC has not defined the term real estate related asset, the SEC staff considers a loan a Real Estate Related Asset if at least 55% of the fair market value of the loan is secured by real estate at the time the entity acquires the loan. The SEC staff has also taken the position that interests in securities backed by mortgages or other interests in real estate, or interests in companies that invest in mortgages or other interests in real estate are Real Estate Related Assets. See, Investment Company Determination Under the 1940 Act: Exemptions and Exceptions, by Robert H. Rosenblum, published by the ABA Section of Business Law, §15.4.

Regulatory Conclusions Unique to Real Estate Funds

A Real Estate Fund should generally not be subject to regulation under the Advisers Act or the Investment Company Act if it invests solely in (1) direct fee interests in real estate; (2) single-member limited liability companies that invest solely in direct fee interests in real estate or (3) majority controlling interests in limited liability companies, or general partner interests in limited partnerships, that invest in real estate. This is because these types of interests should generally not be deemed to be a security, and therefore the fund will not involve in investing in securities at all, which is a prerequisite to regulation under the both acts. Where, however, a Real Estate Fund does invest in securities, it may be able to rely on the 3(c)(5)(C) Exception, which is in many ways more favorable than the 3(c)(1) and/or 3(c)(7) Exceptions, and may also cause the fund's RAUM either to be low enough (i.e., under $150 million) that the manager can meet the "Private Fund Adviser" exemption under the Advisers Act or a similar exemption under the applicable state law.

Conflicts of Interest

Real estate fund managers often have conflicts of interest that are different than those of other private equity fund managers. As always, it is important to identify those conflicts, disclose them to potential investors and create mechanisms for addressing them as they arise. Two such possible conflicts include:

Use of Affiliates to Provide Services

A primary conflict of interest that arises in Real Estate Funds is the use of affiliates to provide services to the fund at rates determined by the fund sponsor. Some examples of these kinds of services include acquisition management, development management, construction management, leasing management, property management, and disposition management. In 2015, SEC Chair Mary Jo White stated that the staff is particularly concerned about this conflict. She said that the SEC staff is "concerned that disclosure about these arrangements may be non-existent or potentially misleading, particularly with regard to whether or not the related parties charge market rates." Keynote Address at the Managed Fund Association: "Five Years On: Regulation of Private Fund Advisers After Dodd-Frank", by Chair Mary Jo White, MFA Outlook 2015 Conference, October 16, 2015, New York. It is very important for Real Estate Fund managers both to disclose any fees that the fund will pay to related parties, to disclose the amount of those fees, and to have a mechanism (such as requiring Limited Partner Advisory Committee consent) for determining the amount of any fees to related parties that were not-disclosed (and, perhaps even those that were), to be sure that they are at market rates. Real estate fund managers should also maintain documentation that evidences that payments to related parties are at market rates.

Allocations of Overhead

Another area of potential conflict for Real Estate Fund managers is the allocation of overhead expenses to the fund. In general, fund managers typically are restricted under fund governing documents from allocating any of their overhead to the fund. Real Estate Fund managers need to be very careful, therefore, if they want to pass salaries of real estate professionals under their employ to the fund (as they sometimes wish to do and believe is appropriate, because the use of their own employees eliminates the need to pay an arguably less-qualified third party to do the work for the fund). If the manager plans to use this practice, then they should clearly disclose it in the offering documents, have a mechanism in place to ensure that the fund is paying market rates, and have an allocation procedure in place if the personnel serve multiple funds or business lines of the manager.

Fund Economics

There are some key ways in which Real Estate Fund economics potentially may vary from those of other private equity funds.

Dual Waterfalls

The primary potential variation can arise where the Real Estate Fund has current income (e.g., rents from leases or other forms of operating profit). While in most private equity fund waterfalls (and even many Real Estate Fund waterfalls) current income flows through the waterfall in the same manner as other income, some Real Estate Funds have separate waterfalls for current income and disposition proceeds. This occurs most often in Real Estate Funds that focus on current income generation (e.g., funds that focus on investments in net lease property). There are many different potential variations on how the dual waterfalls will work, but often the waterfall for current income will allow the general partner to start receiving a carried interest once the limited partners receive a certain preferred return (even if they have not yet received a return of their capital, as would typically be the case if there were a single waterfall and likely will be the case in the disposition proceeds waterfall).

Hurdles

The use of hurdles is relatively common in real estate joint ventures, and as a result some Real Estate Fund managers also use hurdles as part of their fund waterfalls. These hurdles may be based on equity multiples, or they may be based on internal rates of return.

Tax Considerations / Structuring

The following are selected U.S. federal income tax consequences arising from investments in U.S. Real Estate Funds.

UBTI / ECI / FIRPTA

U.S. tax-exempt fund investors are often sensitive to unrelated taxable business income (UBTI, which can arise in Real Estate Funds that use leverage, which most do, or from dealer property, as described below). Foreign investors are generally sensitive to effectively connected income (ECI, which can arise in Real Estate Funds with operations that rise to the level of a trade or business or under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) as described below). Many non-real estate private equity funds use "blockers" to block UBTI to tax-exempt investors and ECI to non-U.S. investors, and to avoid the need for non-U.S. investors to file U.S. tax returns as a result of their fund investment. FIRPTA raises special considerations, however, for Real Estate Funds. Specifically, FIRPTA taxes non-U.S. investors (including non U.S. entities or individuals that invest in a U.S. Real Estate Fund) on gains from U.S. real property investments, at effective rates up to 35% (or, as high as 54.5% when the "branch profits tax" is added). FIRPTA also requires non-U.S. investors to file U.S. tax returns. While a thorough discussion of the different ways in which Real Estate Funds may address and attempt to mitigate the issues related to FIRPTA is beyond the scope of this practice note, two possible approaches include:

Leveraged Blockers

Where a Real Estate Fund wishes to attract non-U.S. investors concerned about ECI, FIRPTA, and U.S. tax filing obligations, a possible solution is the use of a "leveraged blocker" structure in which a U.S. corporation is formed to make the fund investment. In this structure, the U.S. corporation is financed both with equity and debt from its non-U.S. investors. The goal of this structure is to reduce the effective rate of U.S. tax that the non-U.S. investor will be required to bear and to prevent the non-U.S. investors from being required to file U.S. tax returns. The debt must be carefully structured in order to navigate the U.S. tax rules applicable to such an arrangement.

Domestically Controlled REITs

Where a real estate fund wishes to attract either non-U.S. investors or UBTI-sensitive U.S. tax-exempt investors, it might also consider the use of a domestically-controlled REIT. Tax filing obligations for non-U.S. persons do not apply to ordinary distributions (e.g. dividends derived from rents) from domestically-controlled real estate investment trusts (REITs) and FIRPTA does not apply to gains that investors realize from the sale or exchange of domestically-controlled REIT shares. Likewise, UBTI does not arise under a REIT structure. Under recent legislation, non-U.S. investors treated as "qualified foreign pension funds" may also prefer structuring U.S. real estate investments through private REITs, as gains from both property and share sales are exempt from FIRPTA and under certain treaties the tax on operating income may be effectively reduced or eliminated. However, REITs are subject to a number of limitations as to their permitted assets and income and the tax benefits of this structure may be outweighed by such limitations and the costs of establishing and operating this kind of REIT.

"Dealer Property" Issues

Unlike most private equity funds, Real Estate Funds may encounter issues related to taxation as "dealers." Specifically, real estate deemed held for investment is subject to favorable capital gain tax rates, while real estate treated as "dealer" property is subject to ordinary income rates. The classification of real estate for this purpose is a facts and circumstances test. Some primary indicia of dealer property classification include the owner's intention when it purchases the land to develop it for sale (rather than hold it for investment), frequent sales of land, efforts to increase land values through development and improvements, and significant efforts to market and negotiate sales of the property. Some Real Estate Funds may structure their investments to reduce the chance that they will be seen as dealer activity, including by stating in their governing documents that the fund's purpose is "investment" activity, holding real property for investment for at least one year after completion of development activities, and selling properties in bulk rather than one by one.

Conclusion

Real Estate Funds are a significant portion of overall private equity funds, and an important part of the U.S. economy. Partially as a result, Real Estate Fund managers have come under heightened regulatory scrutiny, and therefore need particular guidance from their counsel. It is important that counsel assist their Real Estate Fund clients in analyzing whether and where they may need to register as investment advisers, help them with the resulting regulatory process and obligations, and also help prepare them for regulatory examination. Likewise, Real Estate Fund counsel should help managers identify, disclose, and mitigate all potential conflicts of interest. In preparing fund documentation, Real Estate Fund counsel may be asked to help draft economic provisions that are different than those in traditional private equity funds. Counsel also needs to consider the unique tax issues that arise from investments in real estate. In summary, to be effective counsel to Real Estate Fund clients, attorneys should familiarize themselves with the matters raised in this article and keep in mind that Real Estate Funds, while similar in many ways to other private equity funds, require specialized analysis.

Related Content

For additional information on Private Equity Investments, see the following practice notes:

- Raising Capital Using a PIPE
- Structuring Private Equity Investments
- Understanding and Negotiating Control and Liquidity Rights in Private Equity M&A Deals
- Using Capital Structure Mechanisms to Maximize Returns in Private Equity Investments
- Venture Capital Funds

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