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Private Equity Law Report
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Fund Structures

PE Real Estate Funds: Structuring by Investor Type and Distinct Statutory Considerations (Part One of Three)

Aug. 13, 2019
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A recent webinar sponsored by Strafford CLE Webinars, entitled "Private Equity Real Estate Fund Formation: Capital Raising, Regulatory Issues and Negotiating Trends," discussed some of the structural considerations and legal complexities of forming, launching and operating a private real estate fund. The program featured Ropes & Gray partner Matthew Posthuma and Kilpatrick Townsend & Stockton partner Heather L. Preston.

This first article in a three-part series details the typical range of investment strategies for real estate funds and ways the fund structure can be adjusted to suit the traits of investors. The second article will explore the use of a private real estate investment trust (REIT), along with other vehicles and structures that can be used for real estate funds. The third article will describe tax issues arising from the recent Tax Cuts and Jobs Act of 2017 that specifically apply to real estate funds.

For further commentary from Ropes & Gray partners, see our two-part series "Survey and Forum Consider Credit Fund Structures, Leverage, Conflicts of Interest and Challenging Environment": Part One (Jul. 19, 2018); and Part Two (Jul. 26, 2018).

Types of Fund Strategies

Posthuma outlined a range of strategies that real estate funds tend to pursue, including:

- *Core Funds*: These funds typically hold recently constructed, high-quality buildings that are fully leased to high-quality credit tenants. They usually have low debt, and their income is primarily current income from leases.
- *Core Plus and Value-Added Funds*: These terms are often used interchangeably. The fund invests in value-add or core-plus assets, which are usually quality properties with some issues (*e.g.*, vacancies or properties requiring upgrades). There is typically higher leverage, and the fund's income includes a greater percentage of capital gain than core funds.
- *Opportunistic Funds*: This is the riskiest strategy, with high leverage and generally more risk in the assets. These funds often engage in ground-up development, and their income is mostly derived from capital appreciation upon sale.

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Funds may also invest in a particular type of real estate asset, which often depends on the expertise of the particular real estate manager. The four "food groups" of real estate are retail, office, industrial and multifamily, and it is also common for funds to invest in hotels or other hospitality assets. In addition, debt funds have become more popular in recent years.

For more on trends in real estate investing, see "Monument Group Roundtable Explores PE Trends Related to Emerging Managers and Real Estate Investing (Part One of Two)" (May 21, 2019).

Investor Types Drive Structure

"One of the most important aspects of fund formation is finding an appropriate structure that can accommodate the tax considerations of different types of investors," said Preston. Prospective investors generally fall into one of several primary categories, including U.S. taxable investors, tax-exempt investors, "super" tax-exempt investors, foreign investors and sovereign wealth funds.

U.S. Taxable Investors

U.S. taxable investors are U.S. citizens or U.S. residents, including individuals and entities that are taxable as either corporations or pass-through entities with taxable partners, said Preston. These investors usually want to avoid entity-level taxes on their investments. As a result, they typically prefer to avoid the use of taxable corporations – both in terms how they invest in a fund or in how a fund invests in real estate, she added.

Tax-Exempt Investors

Tax-exempt investors generally are not taxed on passive types of income, including rent from real property, interest income and dividends, Preston explained. They are, however, required to pay taxes on unrelated business taxable income (UBTI). "Depending on the services offered to tenants of the rental property, or the level of personal property associated with the real estate, certain income from the property may be taxable as UBTI," Preston elaborated.

"In addition, certain types of passive income, including rent from real property, may be recharacterized as UBTI if the real property was acquired using debt." These are known as the "debt-financed property rules," and a portion of the income from the property will be treated as UBTI if they apply, Preston added. For example, if there is 60% leverage on a real estate asset purchase, then 60% of the income from the property will be UBTI to tax-exempt investors.

For more on UBTI in the context of co-investments, see "Regulatory Risks and Important Tax Considerations in PE Co-Investments (Part Two of Two)" (Jun. 25, 2019).

Fractions Rule

Certain tax-exempt investors that are qualified organizations (*e.g.*, educational institutions and pension funds) may avoid UBTI from debt-financed real property when a fund complies with the fractions rule and the financing meets certain requirements, Preston noted.

"In broad terms, the fractions rule prescribes onerous requirements for partnership allocations that are intended to prevent the shifting of tax benefits, such as losses and depreciation deductions, from tax-exempt partners to taxable partners," summarized Preston.

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Qualified organizations will prefer to invest directly into the fund and enjoy flow-through tax treatment, explained Preston, where:

1. the financing meets certain requirements;
2. the fund is able to comply with the fractions rule;
3. the fund only holds real property that generates rental income; and
4. the fund does not otherwise engage in another trade or business.

For a discussion of trends in real estate funds, see "Portfolio Management and Global Trends for Private Equity and Real Estate Funds" (Jul. 2, 2015).

UBTI Blocker

Because of the complexities of complying with the fractions rule, qualified organizations sometimes wish to invest through a REIT. Investing through REITs provides pass-through taxation while simultaneously blocking the UBTI from debt-financed property being passed through to the qualified organization, said Preston.

In addition to paying the required tax, tax-exempt investors that are allocated income subject to taxation as UBTI are required to file U.S. tax returns, Preston continued. "These investors will typically prefer to invest through a blocker entity – either an entity taxable as a corporation or as a REIT," she added.

Uncommon Rental Activity

Finally, if a fund engages in real estate operational activities beyond rental activities (*i.e.*, a hotel), tax-exempt investors (including qualified organizations) usually prefer to invest through a blocker structure to avoid recognizing UBTI, explained Preston. Again, the blocker can be in the form of a taxable corporation or a REIT.

Super Tax-Exempt Investors

"Super" tax-exempt investors are U.S. pension funds that are "considered to be an integral part of a state or political subdivision," said Preston. These super tax-exempt investors are generally treated as being exempt, for U.S. federal tax purposes, from taxation on any of their income, she explained.

The result is that these investors are usually open to different types of real estate assets and investment structures, although they typically avoid investing in a fund or in real estate through taxable corporations, noted Preston. "Depending on the risk profile of particular state pension funds, some may prefer to structure their investments into real estate funds similar to general tax-exempt investors," she concluded.

Foreign Investors

A primary concern for foreign investors is to avoid triggering any U.S. income tax return filing obligations, noted Preston. "Property operations usually rise to the level of a trade or business, such that the income attributable to these operations will constitute taxable effectively connected income (ECI) to a foreign investor" she stated.

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Similarly, the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) rules generally require foreign investors to pay U.S. taxes, and to have U.S. tax return obligations, for any gains from the disposition of U.S. real estate, explained Preston. Under FIRPTA, "real estate" includes direct interests in U.S. real property, as well as stock in certain domestic corporations and partnerships that primarily hold U.S. real property and are either U.S. real property holding corporations or partnerships, she continued. As a result, foreign investors typically prefer to invest through a blocker structure, which can be a REIT or a taxable corporation (either U.S. or foreign).

For more on FIRPTA, see "Tax Expert Provides Insight Into Recent U.S. Tax Court Decision on Taxation of Foreign Investments in U.S. Partnerships" (Dec. 7, 2017).

Sovereign Wealth Funds

In this context, a foreign government includes "its integral parts and controlled entities," said Preston, with foreign pension funds typically meeting these certain requirements.

"Generally, a foreign government is not subject to tax in the U.S. on certain U.S.-source investment income, including income from stocks, bonds or other domestic securities owned by foreign governments" explained Preston. Foreign governments are also not subject to taxes on the sale of U.S. real property holding corporation stocks, she continued, unless the foreign government controls the U.S. real property holding corporation.

This tax exemption does not apply, however, to "income derived from the conduct of any commercial activity, as well as any income received from – or derived from the disposition of any interest in – a controlled commercial entity" Preston noted. "A 'controlled commercial entity' is an entity that engages in commercial activities in which a foreign government holds directly or indirectly 50% or more interest in the entity," she clarified.

According to Preston, foreign entities are also not exempt from tax on income earned from U.S. real property interests or income from the disposition of those interests. Sovereign wealth funds generally prefer to invest through blocker corporations that are subject to U.S. tax so they can maintain their tax-exempt status. "It is important that other investors earn more than 50% by vote and value of the direct or indirect interest in the blocker entity in order to avoid U.S. taxation," she cautioned.

For more on sovereign wealth funds, see "Why and How Do Middle Eastern Sovereign Wealth Funds, Pension Funds and High Net Worth Individuals Invest in Private Funds?" (Jun. 6, 2013); and "Why and How Do Sovereign Wealth Funds Invest in Private Funds?" (Mar. 28, 2013).

Distinct Statutory Considerations

For the purpose of launching and managing a PE real estate fund, most of the applicable statutes (*i.e.*, the Investment Advisers Act of 1940) are the same as with traditional PE funds. There are, however, a couple of specific differences that apply to real estate funds that PE sponsors should be aware of in advance.

Investment Company Act of 1940

A fund manager will generally prefer to avoid registering its fund as an investment company with the SEC, said Posthuma. To that end, in addition to the two common exemptions under

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Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 that most fund managers use, there are two other exemptions that specifically apply to real estate.

See "SEC Clarifies Scope of the "Knowledgeable Employee" Exception for Section 3(c)(1) and 3(c)(7) Funds" (Feb. 28, 2014).

Non-Security Exemption

First, a fund may argue that it falls outside the definition of "investment company" in Section 3(a) because it is dealing with real estate, said Posthuma. Specifically, this means that the fund is not engaged primarily in the business of investing in securities and no more than 40% of its total assets are investment securities. For this purpose, neither owned real estate nor a general partner (GP) interest are considered securities, he explained.

The result is that a fund may avoid Section 3(c)(1) or 3(c)(7) if it invests in real estate rather than securities. In addition, if the fund is investing in joint ventures and has sufficient management rights, it may be able to argue that the investment is more like a GP interest than a passive interest in the securities, thus falling outside the "investment company" definition.

Therefore, it is important to ensure that the fund has sufficient decision-making and governing rights under the joint venture to support the assertion that it is not a passive investment, suggested Posthuma. Majority-owned subsidiaries of the fund are not considered when determining if the Section 3(a) exemption applies, he added.

Section 3(c)(5)(C) Exemption

The second exemption for real estate funds is under Section 3(c)(5)(C), which applies when the fund is acquiring mortgages and other interests in real estate. "This gives a little more flexibility than Section 3(a) because you can invest in mortgages as well," noted Posthuma.

There is, however, an argument that a mortgage loan is a debt instrument and therefore a security, which can be problematic, Posthuma observed. This exemption also includes a requirement that the fund not be in the business of issuing redeemable securities. "If you have an open-end fund where the investors have the ability to redeem their interests in the fund on an ongoing basis, it may not be able to rely on Section 3(c)(5)(C)," he cautioned.

ERISA

The Employee Retirement Income Security Act of 1974 (ERISA) regulates employee benefit plans and may come into play when setting up a private fund. ERISA may not apply, however, if benefit plan investors' participation in the fund is less than 25% of total participation and thus considered "not significant," said Posthuma. Notably, a fund may be exempt from ERISA regulation even if the beneficial plan investors' participation exceeds 25% where the fund invests in operating companies, he continued.

See "Private Fund Industry Practice for Defining 'Class of Equity Interests' for Purposes of the 25 Percent Test Under ERISA" (Jul. 23, 2010).

Specifically, this refers to venture capital operating companies (VCOCs), which can only invest in other operating companies, and real estate operating companies (REOCs), which must be involved in the management or development of real estate, Posthuma elaborated. "In each case, the fund must have sufficient management rights in the VCOC or REOC. It is common to see a

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structure where the fund is a VCOC and subsidiaries such as REITs are the REOCs for ERISA purposes," he said.

"When setting up a fund – and before you have that first closing – you need to look at your investor base to determine whether you may have ERISA issues," Posthuma finished.

For more on ERISA as it applies to private fund managers, see our five-part series "Happily Ever After? – Investment Funds That Live With ERISA, For Better and For Worse": Part One (Sep. 4, 2014); Part Two (Sep. 11, 2014); Part Three (Sep. 18, 2014); Part Four (Sep. 25, 2014); and Part Five (Oct. 2, 2014).

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