

3 Developments Real Estate Fund Sponsors Should Know for 2015

Changes in fee terms as well as new guidance regarding GAAP consolidation and potential future tax developments can impact how fund sponsors structure and negotiate their investment vehicles.

Despite a slight downturn in capital-raising activity during 2014,¹ US real estate fund sponsors can expect 2015 to support overall fundraising success as a result of a variety of economic factors. In doing so, however, sponsors should be cognizant of the latest trends in fee terms, new accounting guidance and potential developments in future tax rules. This *Client Alert* highlights these trends and potential developments.

1. Trends in Fee Terms

Recently, the Pension Real Estate Association (PREA) released its 2014 study of fee terms — including both management fees and incentive fees (aka “carried interest” or “promote”) — associated with 164 private real estate investment vehicles targeting institutional investors and investing in all types of US and non-US real estate. Among other things, the study revealed the following:

- The most typical basis for management fees for closed-ended funds was limited partner commitments during the investment period, and invested equity thereafter. Open-ended funds, separate accounts and joint ventures were much more likely to utilize a different basis and typically did not apply different bases over time. The most common management fee basis for open-ended funds was net asset value.
- The median rate applied to closed-ended funds using invested equity as a management fee basis was 1.5 percent, with a fairly sizable standard deviation of .41 percent (*i.e.*, just over 2/3rd of such fee rates fell between 1.91 percent and 1.09 percent.) For open-ended funds using net asset value as their management fee basis, the median rate was .99 percent, with a standard deviation of .11 percent.
- Almost all closed-ended funds (the vast majority of which pursued a value-added or opportunistic strategy) charged some type of incentive fee, but more than a third of open-ended funds (the vast majority of which pursued a core strategy) did not.
- Incentive fees charged to closed-ended funds most often (69 percent of the time) took into account a 100 percent return of capital as part of the determination of when such fees are distributed. But there

was a significant difference based on fund vintage, with 64 percent of pre-2011 funds and 88 percent of post-2010 funds using such test.

- A majority (almost 60 percent) of closed-ended funds used a catch-up in calculating incentive fees, but catch-ups were almost never used for open-ended funds. The catch-ups which closed-ended funds used were most often (66 percent of the time) a 50-50 general partner-limited partner (GP-LP) split or a 60-40 GP-LP split.
- Closed-ended funds not using a catch-up (the vast majority of which pursued a value-added strategy) set their first “hurdle” at which incentive fees begin to be distributed (most commonly expressed as an internal rate of return or IRR) at 9.21 percent on average. The average incentive fee rate for such vehicles was 18.54 percent. The 2014 study did not separately report first hurdle rates and incentive fee rates for closed-ended funds using catch-ups or for open-ended funds (in isolation), nor the use of additional hurdle rates and incentive fee rates for all closed-end funds not using a catch-up.²
- Only a minority of closed-ended funds or open-ended funds charged other types of fees for managing the funds, such as acquisition fees (25 percent for closed-ended and 24 percent for open-ended), debt arrangement fees (4 percent for closed-ended and 19 percent for open-ended) or disposal fees (1 percent for closed-ended and 5 percent for open-ended).
- Study participants noted a trend of real estate investment vehicles aligning fees to achieve more transparent fee structures, although participants also believed that existing funds had implemented only a few changes in fee structures over the past two years.

Although many of these trends are not particularly surprising, this study is a very helpful confirmation of our anecdotal experiences. Indeed, a number of investors have recently cited the study in negotiations with our real estate sponsor clients, particularly when the investors view the information as revealing “off market” fee terms. Sponsors ignore this information at their negotiating peril.

2. New US GAAP Consolidation Guidance

In July 2014, the Financial Accounting Supervisory Board (FASB) voted to issue a new consolidation standard affecting the methodology for determining when companies should consolidate limited partnerships or similar entities, including limited liability companies. Under the new guidance:

- FASB will consider all limited partnerships or similar entities as “Variable Interest Entities” (VIEs) unless substantive kick-out rights or participating rights are exercisable by a single limited partner or a simple majority or less (by interests in the applicable entity) of all limited partners (or non-managing members, in the case of limited liability companies). FASB will hold entities determined to be VIEs to certain disclosure requirements and will analyse such entities for potential consolidation with their parent entity(ies) under the revised VIE guidance.
- In determining whether VIEs should be consolidated under such guidance, FASB will consider the size of a general partner’s (or managing member’s) investment in, and the amount and type of fees paid by, the VIE.³
- Fees a VIE paid will not represent a “variable interest” (triggering consolidation) if all of the following requirements are satisfied: (i) the decision maker’s compensation is commensurate with the services provided; (ii) the compensation agreement is on terms and conditions that are customary for similar services negotiated on an arm’s-length basis; and (iii) the decision maker does not hold other interests in the entity that, individually or in the aggregate, absorb more than an insignificant amount

of the entity's expected losses or receive more than an insignificant amount of the entity's expected residual returns.

These consolidation rules are most immediately of interest for real estate fund sponsors with a publicly traded parent concerned with reporting consolidated information on the parent's balance sheet that may be inconsistent with the amount of such parent's true financial investment in, or exposure to, a subsidiary fund or similar vehicle. Conversely, real estate fund sponsors without a public parent may not be particularly concerned with such GAAP-driven consolidation, as sponsors may feel that they can adequately explain the resulting balance sheet to their private investors without a public reporting overlay. In any setting, however, this new guidance represents a significant departure from prior rules, and sponsors therefore should consider the guidance when structuring (or restructuring) real estate funds.

3. Recent Tax Proposals and Potential Tax Guidance

In 2014, the US House Committee on Ways & Means considered two carried interest reform proposals, introduced by Congressman Sander Levin and Congressman Dave Camp, respectively.

- The Levin proposal was very similar to legislation that had been introduced on several other occasions regarding the treatment of carried interest. It would provide that all income allocable to designated service partners be taxed at ordinary income rates except to the extent the income is attributable to certain qualified capital interests
- The Camp proposal was more interesting, because it adopted a new approach to the issue. That proposal would calculate a deemed interest amount on the amount of capital that is treated as supporting a partnership's carried interest, determined by applying the same percentage used to calculate such carried interest to the partnership's total capital (e.g., 20 percent of total capital if carried interest is 20 percent). The resulting deemed interest amount would be ordinary income until it exceeded the amount determined by applying the long-term applicable federal rate (AFR) plus 10 percentage points to that amount of capital. Thus, the compensatory element would be that amount of carried interest income equal to interest at the long-term AFR plus 10 percentage points on a loan equal to the investment underlying the carried interest (or the totally carried interest amount, if less). The Camp proposal applies to interests in partnerships received in connection with the performance of services by a taxpayer in an "applicable trade or business." Based on the statutory definition, whether this provision would apply to partnerships owning real estate remains unclear.

Also, on August 26, 2014, the IRS released its 2014-2015 priority guidance plan, which highlights areas of guidance that the IRS intends to develop between the last half of 2014 and the first half of 2015.

Among other things, the plan addresses:

Guidance on management fee waivers. The IRS is studying management fee waiver structures to provide guidance on permissible fee waivers. Although specifics are still unclear, the IRS has informally raised two specific issues in connection with those arrangements — whether the interest in a partnership attributable to certain permitted waived management fees is treated as a profits interest in the partnership, and whether the waiving manager should treat waived fees as constructively received.

Simplifying regulations for fractions rule compliance. The IRS is also studying changes to simplify compliance with the fractions rule. This rule is complex and difficult to work with. The following issues are either problematic or a source of uncertainty in attempting to comply with the fractions rule:

- Charging different levels of management fees for different fund investors

- Complying with the fractions rule by subsidiary entities, including joint ventures
- Determining whether a loss is an “unlikely loss” that can be ignored
- Carried interest clawbacks

Although these proposals and guidance have not yet been adopted, real estate fund sponsors should monitor them closely as these possible changes could significantly affect the sponsors’ businesses if they become effective and are not appropriately addressed.

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Endnotes

- ¹ See Pension Real Estate Association report “PREA-ANREV-INREV Management Fees & Terms 2014 - A Comparison Study” as described in Law360 article [Real Estate Fund Closings Dropped In 2014, Study Says](#).
- ² Note: Without such additional information, the average first hurdle and incentive fee rates for the relatively small number of closed-ended funds not using a catch-up appears to be of limited utility. In addition, in our experience hurdle rates tend to be highly variable depending on vehicle type and investment strategy, making averages of such figures (without information on standard deviation or similar measures) potentially misleading.
- ³ Interests held by and fees paid to parties related to the general partner (or managing member) also need to be evaluated in such analysis.