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Nontraded REITs and closed-end funds: Key differences investors should understand

High-net-worth individuals who are seeking a diversified portfolio may benefit from exposure to private markets. Private real estate, in particular, may offer diversification from public market volatility, serve as a potential hedge against inflation, and provide certain tax benefits that are less common in public market investments.

Once an investor makes the decision to invest in private real estate, the next consideration is which investment structure is best positioned to meet their goals. Investors may pursue an active direct investment or an investment in a single-asset syndication, but two of the most common options, in terms of investment volume, are closed-end real estate funds and nontraded REITs.

Both nontraded REITs and closed-end real estate funds seek to offer investors access to a diversified pool of real estate investments. The specific thesis of each vehicle can vary in size, asset type and geography, but the general objective is relatively consistent.

Fund life cycle

In general, nontraded REIT structures tend to be open-end vehicles, allowing for new investors and redemption options for existing investors (although redemptions may have restrictions). The vehicle is usually evergreen, meaning it is structured without a defined termination date. By contrast, a closed-end real estate fund offering, as the name suggests, typically admits investors only during a defined offering period and eventually sells all its assets and winds down the fund.

Liquidity

Nontraded REIT vehicles typically offer investors the opportunity to redeem their shares from the fund at the current net asset value (NAV). Many investors find this liquidity feature to be attractive, as it theoretically allows the investor to pivot quickly if their investment objectives change. Though there is some liquidity built into the offering structure, it is critical for investors to understand that liquidity availability may be limited. Nontraded REIT vehicles typically limit redemptions from the fund, which can be constrained by a percentage of an investor's assets, the total fund NAV or at the REIT manager's sole discretion. It's important for the manager to have these limitations in place, as the underlying assets of the fund are still illiquid investments. In order to accommodate redemptions, fund managers must keep more cash on hand or have other mechanisms in the portfolio to access liquidity, both of which may create a drag on returns (for example, instead of investing in a real estate opportunity, they may have to hold cash in reserve for redemptions). The concept of forcing liquidity onto an illiquid asset class is often referred to as an asset/liability mismatch and can result in the actual liquidity available to the investor being far less than expected.

Closed-end funds tend to be even more illiquid. Once an investor is in the fund, they are generally in until the fund winds down, which often ranges from five to 12 years. For investors participating in closed-end vehicles, it is critical to have a keen sense of what their future liquidity needs might be. Because of this illiquidity, closed-end real estate funds generally target a higher total return (often referred to as an illiquidity premium) as compensation for the illiquidity risk. Because closed-end fund managers don't have to worry about satisfying redemptions, they have more freedom to focus on investing in the fund's target asset types.

Management compensation

Management fees – Managers typically earn a recurring management fee that is calculated as a percentage of assets under management. It's critical for investors to understand what asset base is used for the manager's fee calculation. In closed-end real estate funds, it's common for the fee to be calculated on contributed capital. This means that if the fund size is $400 million of equity and a manager takes a 1.25 percent annual management fee, the manager will collect $5 million annually regardless of whether that $400 million is worth $300 million or $500 million. For funds that are performing well, this structure is beneficial to investors. Assuming the $400 million fund is now worth $500 million, the fee burden is still only $5 million annually, which is 1 percent of the fair market value of the investor equity. In the case where a $400 million fund is worth $300 million, the $5 million annual management fee is closer to 1.67 percent on the fair market value (FMV) of the investor equity.

Open-end funds like nontraded REITs generally calculate fees as a percentage of the net asset value (NAV). This means the manager's compensation goes up and down as the value of the underlying assets go up and down. This can cut both ways, as investors are paying more fees when the fund is performing well, but also can see relief from fees when the fund is underperforming. In addition to understanding the fee structure, investors should understand how the fund's assets are valued, as the manager could be incentivized to overvalue the underlying assets to create a higher NAV and, in turn, collect higher fees.

Carried interest/performance fees – In many private investment vehicles, managers earn a percentage of profits after achieving a specified hurdle return for investors, typically referred to as carried interest or profits interest. Once the return threshold is achieved, there is a wide variance of what percentage of profit goes to the manager; however, this commonly ranges from 20 percent to 30 percent. Investors should understand the following two concepts around how managers calculate a profits interest:

- **Asset-by-asset or fund total:** Some managers calculate their profits interest based on the performance of each individual asset in the fund. Other managers calculate their profits

interest based on the overall performance of all assets in the fund. In scenarios where managers calculate profits interest on an asset-by-asset basis, lower-performing assets will not offset the manager's profits interest in high-performing assets; and therefore, managers may receive more profits interest in asset-by-asset scenarios than they would if the profits interest was calculated on the entire fund portfolio.

- **Realized vs. unrealized:** Another important question is whether the manager's return is calculated on realized or unrealized investments. Some funds only calculate their profits interest when assets are sold and cash is sent out to investors, while others make the calculation based on the current value of the assets, regardless of whether they've been sold at that value. As mentioned in the management fee discussion above, it becomes critical to understand how the assets in the fund are valued, as a manager who is compensated on unrealized asset values could be incentivized to show inflated asset values.

  While closed end funds may structure their profits interest calculations in several ways, it is common for them to calculate their profits interest on the whole fund and on realized investments. Due to the perpetual nature of open-end funds, these funds must either calculate their profits interest based on realized asset by asset sales or based on the unrealized overall fund performance in a given interval of time (often quarterly or annually). This is usually done by internal or external valuations of the fund's assets.

Tax outcomes

Finally, the last consideration for investors to be aware of when weighing the two investment vehicles is tax outcomes. Investors should understand the after-tax consequences of their chosen structure. Real estate is generally a tax-advantaged asset class because of the ability to depreciate a significant portion of the property.

Open-ended REIT vehicles are subject to REIT taxation rules. Tax depreciation from the properties can be passed to the REIT entity itself, and the REIT can generally utilize the depreciation deductions to reduce its taxable income but cannot pass taxable losses to REIT shareholders. A REIT must separately calculate earnings and profits (E&P) depreciation, which is then factored into calculations to determine the tax classification of distributions to REIT shareholders. E&P depreciation is generally lower than tax depreciation due to the requirement to utilize longer class lives and inability to utilize bonus depreciation. Early in a REIT investment, distributions are often classified as "return of capital" and are not immediately taxable. Over time, the tax efficiency of these distributions may decline, and investors could eventually begin to see taxable income from the REIT. This income can come in the form of a capital-gain dividend when assets are sold but can also sometimes come through as REIT ordinary dividends. REIT ordinary dividends can be eligible for a qualified business income (QBI) deduction that can be up to 20 percent, subject to applicable rules and limitations.

Private closed-end funds can be taxed in different ways depending on their structure, however, a common structure used is an entity that is taxed as a partnership which can include multimember LLCs. Funds that are taxed as partnerships can pass depreciation benefits directly to investors, who may receive significant paper loss allocations in the early years of their investment. For investors that have other passive income in the same tax year, these losses may be released and help reduce the investor's taxable income in that year. For those without other passive income, these losses can be carried forward indefinitely to future years where the investor has passive income or be released upon disposal of the activity. The tax efficiency of closed-end funds taxed as partnerships can be advantageous for certain investors, though it often comes with additional complexity that may not be appropriate in all cases. Investors should consult with their tax adviser on whether the potential benefits outweigh the costs.

Making the choice

In the end, both vehicles can get investors exposure to private real estate, but there are important differences to consider. MLG Capital can help investors weigh those differences and find the right investment vehicle to meet their goals.

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CORPORATE OVERVIEW

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