

Tokenization Of Real Estate: *What, Why And How*

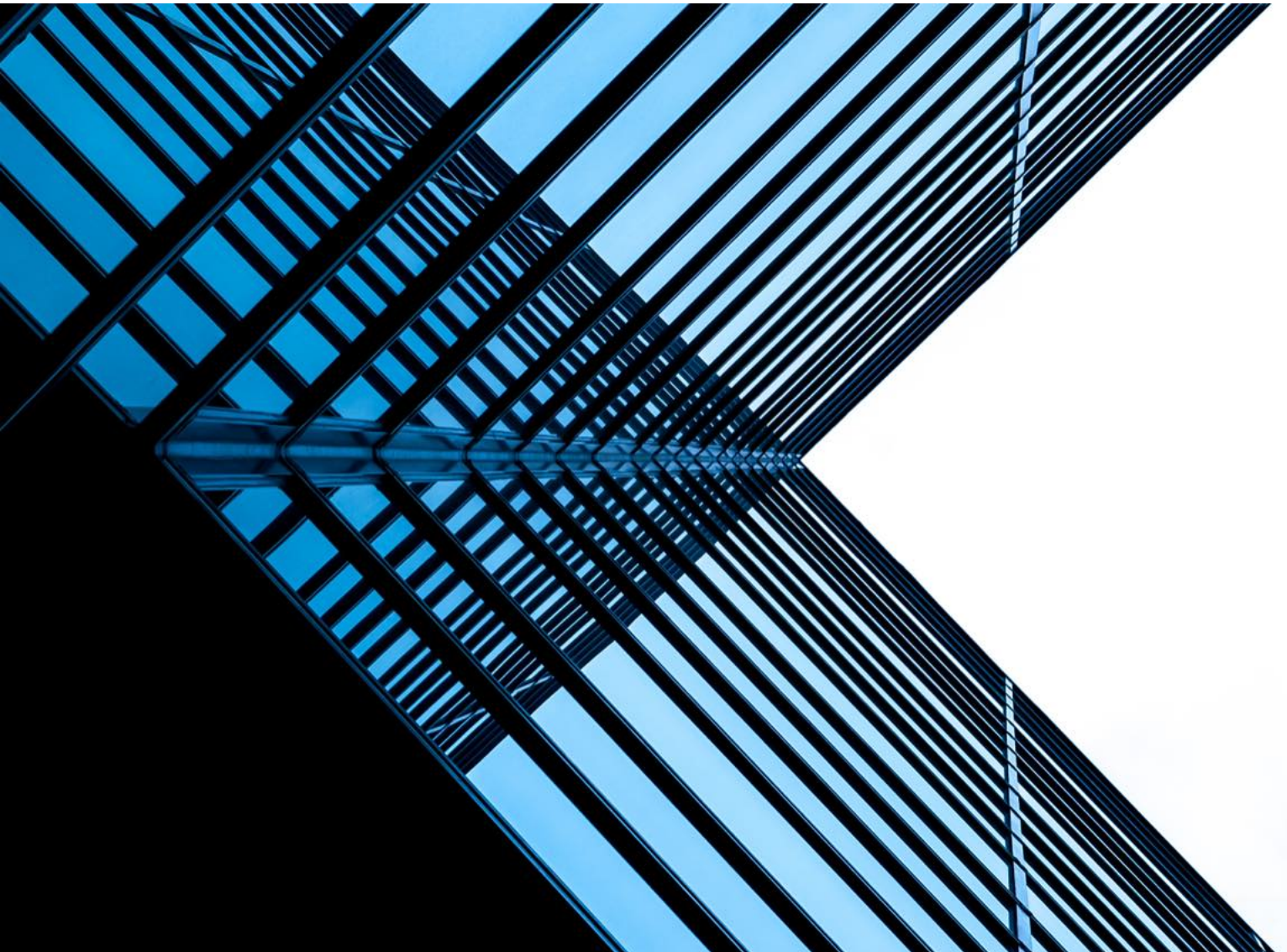


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Tokenization Of Real Estate: What, Why And How

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Real estate has nearly always been considered a relatively safe investment. After all, whatever happens in the stock market, people will always need a place to live and work. Yet, real estate transactions also tend to be some of the most complex and expensive, rendering real estate itself relatively illiquid.

In recent decades, securitization has had some success in making real-property interests easier to deal in. But a new method of engaging in such transactions promises to go even further in transforming the purchase, holding, and sale of real property: Tokenization. Tokenization involves representing ownership of an interest in real estate with virtual tokens that exist on a blockchain (forming a type of security token). The core technology is the same underlying the popular cryptocurrency Bitcoin

and the many initial coin offerings that have characterized the last year and a half but adapted to be compliant with securities regulations.

Tokenization and the blockchain offer numerous advantages over traditional methods of dealing in real estate. These include increased liquidity and transparency, enhanced security, and simplified management.

But tokenization is also a highly complicated process, both technically and legally. Companies interested in launching a real-estate-backed virtual token must carefully consider and resolve a wide range of issues when planning, developing, and launching their real-estate token.

What Is The Tokenization Of Real Estate?

Tokenization is the process of creating a virtual token to represent ownership of a real estate interest. Rather than dealing with regular real estate interests in an outdated manner using paper documents, purchasers are able to engage in transactions digitally using tokens.

Tokenization is flexible: A token could represent ownership of the underlying real asset, an equity interest in a legal entity that owns that asset, an interest in a debt secured by the asset, a right to share in profits arising from the use of the asset, or more.

The types of the real property involved can also vary widely, including single-family homes, multifamily structures, office buildings, warehouses, retail spaces, and everything in between.

Although this may sound like science fiction, several models of real-estate tokenization are already being actively developed, such as:

- ✓ Ownership of real estate through a special-purpose vehicle (discussed in more detail below);
- ✓ Shares in real-estate funds;
- ✓ Timeshares;
- ✓ Investments in and loans to development projects; and
- ✓ Tokenized REITs.

Advantages Of Tokenization



Tokenization could revolutionize the global real estate market. It offers issuers and investors several significant advantages over existing investment options and could introduce large numbers of new investors to the market. Tokenization's advantages include increased liquidity and several other advantages discussed below.

Other Advantages Of Tokenization

- ✓ **Transparency.** A blockchain is a public ledger, recording every transaction involving the cryptocurrencies and virtual tokens running on it. This structure makes it impossible for a tokenholder to “double-sell” a token—accepting a transfer for the same token to two different sources.
- ✓ **Security.** Blockchains are distributed ledgers, which means that no one person, group, or organization controls them. In addition, blockchains rely on advanced cryptography to provide security to users. Each user has his or her own private key that allows access to his or her blockchain assets. That key is a long string of random characters that is very difficult for a computer—let alone another user—to guess.
- ✓ **Immutability.** After a transaction has been recorded and confirmed on the blockchain, it essentially cannot be changed. This helps assure investors that no one can falsify transactions after the fact. (Of course, this could be a double-edged sword. A fraudulent or mistaken transaction may be difficult or impossible to reverse.)
- ✓ **Simplified Management.** Tokenization can also lead to easier management of investors and their rights. Secondary transactions can be easily tracked by collaborating with third-party exchanges. And investors can receive distributions and exercise their other rights (e.g., voting) through the blockchain, simplifying those processes considerably.

Tokenization Strategy: Legal And Other Considerations



Companies interested in developing a real-estate token must carefully consider a host of legal and other issues in connection with their offerings. These issues are highly complex and require the assistance of experienced real estate, securities, tax and blockchain attorneys and other professionals.

Some of the most significant issues that must be considered and dealt with are:

- ✓ Type of Interest
- ✓ Securities Regulations
- ✓ Asset Type
- ✓ Tracking Tokenholders
- ✓ International Sales
- ✓ Legal Entity
- ✓ Corporate Code
- ✓ Location
- ✓ AML/KYC/Investor Accreditation
- ✓ Smart Contracts
- ✓ Tax and Reporting Considerations
- ✓ Tokenization Ratio
- ✓ Mortgage Issues

Type Of Interest

Developers of virtual tokens could choose to tokenize the real estate itself, an equity interest in a legal entity that holds the real estate, a mortgage of the property, a right to share in revenue or profits generated by the property, or any other variation. The nature of the interest being tokenized may impact what regulations apply to the token.

For example, if a token that qualifies as an equity security is held by at least 2,000 people (or 500 people who are not accredited investors) and the issuer of the token has more than \$10 million in total assets, the security must be registered under the Securities Exchange Act of 1934. This requirement is in addition to the general securities-registration requirement discussed below.

Legal Entity

Securitization of real estate has traditionally relied on the establishment of a special-purpose vehicle (SPV) and tokenization will likely do the same. An SPV is a legal entity that exists for a single business purpose, such as to hold and manage real estate. An SPV can be a trust, limited partnership, corporation, limited liability company, or other entity, each of which has its own advantages and disadvantages.

If properly structured, the SPV's assets and liabilities are considered separate from those of the developer (i.e., the company that establishes the SPV) for accounting, tax, and bankruptcy purposes. This allows the tokens to stand on their own merit as investments, without regard to the creditworthiness of the developer.

However, structuring the SPV, its ownership, and transactions between it and the developer is highly complicated, requiring the assistance of experienced professional advisers.

Smart Contracts

Smart contracts are computer code existing on a blockchain that automatically implements and enforces agreements between users without human intervention. Because a smart contract is connected to a blockchain, it cannot be altered once published. Consequently, the smart contracts used to define a token's characteristics and process sales of the token must be carefully designed and vetted before launch.

Smart contracts' design must effectuate the characteristics the issuer desires for its token. For example, if tokenholders are to receive dividends or otherwise share in profits, the smart contract must so provide. Doing so effectively requires answering questions such as the following:

- ✓ Are distributions mandatory or discretionary?
- ✓ For how long must tokenholders hold their tokens to be eligible for a distribution?
- ✓ On what date will tokenholders' eligibility for distributions be assessed?
- ✓ How will the amount of distributions be determined?
- ✓ On what date will tokenholders' eligibility for distributions be assessed?
- ✓ How will withholding be handled?

Best practices would be to have smart contracts undergo thorough technical security audits to identify and correct any security flaws in the code. Failure to do so may require burning and reissuing tokens to investors, a costly, embarrassing, and unnecessary process. Even worse, a faulty smart contract could result in the theft of the tokens by hackers.

One keynote is to understand that smart contracts do not replace lawyers; in fact, there is a substantial gap between the requirements of law and the limitations of smart contracts. It's important to understand what functions can be effectively handled by smart contracts and what cannot. In certain circumstances, a legal override may be necessary, while in other circumstances, it's imperative that the smart contract is adapted to accommodate a necessary legal requirement.

Securities Regulations

Real-estate tokens will virtually always qualify as securities under state and federal law. As such, they must be registered with the Securities and Exchange Commission (SEC) or satisfy an exemption from registration. Failure to satisfy this requirement can result in substantial civil penalties and give investors a right to rescind their purchases and receive a full refund.

Of course, most issuers will not seek to register with the SEC, but structure their security token offerings as exempt transactions. In doing so, they will choose from among several available exemptions, including Regulation A+, Regulation CF, Regulation D, and Regulation S.

These regulations impose different requirements on the offering, from limitations on who may invest, to limits on the amounts raised, to resale restrictions on investors. Which is best in any given security token offering will depend on a number of factors and should be discussed with a knowledgeable securities lawyer.

Tax And Reporting Considerations

Although the Internal Revenue Service has provided general guidance regarding the taxation of “virtual currencies” like bitcoin, many aspects of how U.S. tax law treats the purchase, holding, disposition of, or income from virtual tokens remains uncertain. Issuers and investors should consult a tax professional for help in developing a comprehensive tax strategy.

Moreover, issuers must be aware of any reporting requirements they may have, tax-related or otherwise. For example, issuers that rely on Regulation A+ for an exemption from registration under U.S. securities laws may be required to file regular reports with the SEC after the offering.

Other Considerations

Asset type. If the asset is income-producing, who will decide how that income is used? Tokenholders? A board of directors, trustee, or general partner? A smart contract?

Tokenization ratio. It is possible to tokenize only part of a property rather than the entire property. In that case, however, the details of the arrangement must be negotiated between the owners and made clear to potential investors.

Mortgage issues. If the property being tokenized is subject to a pre-existing mortgage, the issuer will usually need to obtain the mortgagee's consent or pay off the mortgage. If the tokenization is effectively a mortgage itself, then the proper laws will need to be observed.

International sales. Most countries have their own securities laws and AML/KYC rules. This means that issuers must be mindful of the varying regulatory regimes into which they are launching their tokens. A security token offering that is legal in Europe, for example, may be illegal in the United States—or vice versa. In fact, it's possible that one country might treat a token as security while another country does not.

Other legal and regulatory regimes. Virtual tokens are subject to more than just regulation as securities. Depending on the features of a token, it may also be regulated under money-services laws and commodities regulations, in addition to general anti-fraud and consumer-protection laws.

Location, location, location. The location of real estate is important for practical reasons (e.g., nobody will buy a condo in the middle of nowhere), but also for legal reasons. Not every country provides protections for private property rights as strong as those in the U.S., for example. While the tokenization might happen in a different jurisdiction, one can never escape the situs that which the real estate is actually physically located.

Tracking tokenholders. Identifying how many people own tokens and who they are will be critical for token issuers. This will typically require collaboration with security-token exchanges to track secondary trading and ownership.

AML/KYC/Investor Accreditation. Virtual token issuers must be careful to comply with Anti-Money Laundering and Know-Your-Customer (AML/KYC) laws and regulations wherever they offer their tokens. If relying on a securities-law exemption that only permits accredited investors, issuers must also take reasonable steps to accredit their purchasers. This may include actively verifying that investors are accredited investors rather than just taking their word for it.

Conclusion

Tokenization has the potential to change the way people invest in real estate the world over. But realizing that potential will require significant thought and planning by blockchain developers and their professional advisers. Tokenization is subject to a complicated web of legal and practical issues, any one of which could make the difference between success and failure.

Consequently, developers should consult knowledgeable securities, tax, accounting, and real estate professionals early in the process of planning a real-estate security token. These professionals can help guide the development and launch of the token in a way that minimizes unnecessary risks and costs.

Biography of Guest Co-Author: Jor Law is a pioneer in building out the ecosystem for digitizing and trading securities on the blockchain and other distributed ledger technologies. A corporate, finance, and securities attorney, he is most well-known for his expertise in alternative finance, including EB-5, venture capital, crowdfunding, and initial coin offerings (ICOs) or security token offerings (STOs). He is a co-founder of VerifyInvestor.com, the dominant accredited investor verification service in the world, and a founding shareholder of Homeier Law PC. He is an expert on attracting and verifying accredited investors. Within the crypto space, he's most passionate about securities regulations affecting tokens, identity for regulatory purposes vs privacy and anonymity, and cross-ledger or cross-chain technologies.

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