

SUMMER
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TOKENIZATION

Real Estate Interests
On the Blockchain

↑
NFT
NON-FUNGIBLE TOKEN

Introduction

The tokenization of real estate assets and the use of blockchain technology is a fascinating and potentially impactful development for the global real estate market. But as with any disruptive technology, real estate tokenization raises complex and important legal issues that are essential to explore. In this article, we explain certain benefits of tokenization and address some of the legal and regulatory considerations implicated when employing blockchain technology in the real estate industry.

What Is Blockchain?

Blockchain is most well known as the technology behind digital currencies such as Bitcoin, but blockchains can support a much broader range of transactions. A blockchain is a system of recording transactions on a ledger across a decentralized network of computers. Each transaction is verified by numerous computers, recorded in a block, and broadcast across the entire network, reducing the need for a centralized intermediary to establish trust between counterparties and resulting in what is often referred to as an “immutable ledger.” Should a bad actor attempt to modify the transaction chain, the other computers on the network immediately reject the false transaction. This system is uniquely suited to supporting digital assets because value can be accurately traced and audited.

In recent years, blockchains have also been used to transact in “tokens” that are tied to real-world assets, such as real estate. Tokenization is the process of representing some interest in an asset as a token stored on a blockchain. These tokens can be exchanged directly between participants through “on-chain” transactions. Legal documents can be prepared to allow real estate tokens to represent different types of interests, including an ownership interest in an underlying real property, equity in an entity that owns real property, or interests in debt collateralized by real property. Some blockchains also integrate smart contracts, which are self-executing programs with rules established in code. Smart contracts allow automated transactions by defining a set of parameters that, if met, execute automatically. For instance, smart contracts can trigger payments on agreed-upon dates or at specified benchmarks. As a result, tokenized real estate platforms can potentially allow investors to buy, sell, and swap real estate tokens with predefined rules and with minimal involvement of third-party intermediaries.

Benefits and Business Developments

Tokenization aims to provide renewed liquidity opportunities for real estate assets, along with greater efficiency, cost savings, and democratization.

Increased Liquidity

Tokenization’s most significant benefit to real estate markets is increased liquidity. Real estate has historically been one of the most illiquid asset types, requiring large capital investments, long hold periods, and lengthy, costly transaction processes. Tokenization can increase liquidity by fractionalizing real estate interests into tokens that can be more easily traded. The ability to own fractions of specific properties as tokens offers investors a new means of gaining exposure to real estate assets and trading in real estate assets. Traditionally, a limited partner in a real estate investment may be locked into the investment until the asset matures and the sponsor sells the



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asset. An investor is often forced to hold an investment to maturity without a simple out should the investor's circumstances change. Secondary sales are complex and require finding a qualified buyer to engage in a complicated transaction, incurring high fees and often selling below market value, in part due to the high transaction costs. In contrast, tokenized transactions of any size can be executed directly between verified buyers and sellers on digital marketplaces with nearly instantaneous settlement and negligible fees.

Lower Barrier of Entry

Fractionalized tokenization has the potential to democratize real estate investing by lowering the barrier of entry for investors. Tokenization offers many similar benefits to a REIT but with the potential for lower costs, further fractionalization, and greater portfolio diversification opportunities. For example, a single rental property worth \$5 million could be divided into 5,000 tokens worth \$1,000 each. Investors could then purchase the tokens and receive profits, such as dividends or rental income. When the property appreciates and an investor wants to sell its position, it could trade the tokens on a secondary market. Moreover, similar to a cryptocurrency, real estate tokens can themselves be bought or sold in fractional denominations, such as 0.5 or 0.1 of a token, rather than only in full.

Efficiency

Tokenization also offers efficiency gains and cost savings through automation and disintermediation. Once established, blockchains allow for low-cost issuance, transfer, settlement and trading processes, as well as the ability to automate certain processes via smart contracts. Real estate tokens can be programmed to automate governance and compliance requirements such as transfer restrictions, lock-up periods, voting rights, and dividend payments. These cost-saving efficiencies provide fund managers a seamless method of raising capital from a global pool of potential investors with lower minimum investment requirements.

Additionally, blockchain-based systems provide greater transparency and information access.

Commercial real estate transactions involve many parties, and data is often fractured and obscured among them. Increased access to data on a blockchain can significantly reduce information asymmetry between investors and fund managers by creating a single, "tamper-resistant" source of information, including title history, price history, and debt and transaction records, which in turn aids in efficiency and reduces diligence costs.

Use Cases

According to research conducted by Deloitte and the World Economic Forum, a large part of the future economy will be driven by tokenization, and the business value-add of blockchain technology is projected to exceed \$3.1 trillion by 2030.¹ From June 2021 to May 2022, the total monthly market capitalization of real estate tokens grew from \$65 million to \$194 million, making real estate the largest growing sector of the \$16.4 billion market capitalization of the emerging token economy. Noting this trend, many real estate companies and platform providers are experimenting with tokenization in an attempt to reach a broader pool of investors:

■ Asset management firm Elevated Returns launched a digital security token called Aspen Coin linked to 19% of the equity in the St. Regis Aspen Resort through ownership interests in a special-purpose vehicle. Elevated Returns initially intended to register an IPO but withdrew its application in favor of a token offering. The tokens were sold solely to accredited investors through a Regulation D 506(c) offering, with tokens priced at \$1 each. With an appraised value of \$262 million as of 2019, the St. Regis Aspen Resort was the first trophy real estate asset to tokenize its equity. Elevated Returns plans to tokenize \$1 billion in real estate assets over the next decade.

■ Propy is a peer-to-peer residential real estate platform that enables seamless and nearly

1. "Planning for Blockchain in the Retail and Consumer Packaged Goods Industries," Deloitte, 2018. "Digital Assets, Distributed Ledger Technology and the Future of Capital Markets," World Economic Forum, May 2021.

instantaneous home purchases in the form of non-fungible tokens (NFTs). NFTs are unique digital tokens stored on a blockchain that provide proof of ownership of an asset (similar to a title or deed). For transactions effected using Propy, appraisals and inspections are obtained up front and presented on the marketplace, where buyers can immediately place offers. The NFT purchaser becomes the sole owner of a US-based entity that holds title to the property. Currently, real estate transactions take about 50 days from offer to closing. An NFT-based real estate market has the potential to reduce cost and timing of real property sales significantly through fully online, automated processing.

■ French asset manager Mata Capital issued security tokens for three separate funds worth a combined total of €350 million in real estate assets. One of these tokenization projects involved ownership of a planned 11-story hotel development on the outskirts of Paris. Mata Capital utilized the Ethereum blockchain to automate compliance requirements. Mata's platform performs Know-Your-Customer (KYC) diligence up front, whitelisting (approving) investors who are eligible to invest and allowing the automatic issuance of shares once an investor is verified.

Legal and Regulatory Landscape for Tokenized Real Estate

Despite being home to the largest group of crypto investors, exchanges, and platforms, the US has been slow to adopt comprehensive laws governing digital assets. The recently proposed Lummis-Gillibrand Responsible Financial Innovation Act could provide hints as to where regulation is headed. However, the act has not yet made its way through Congress into law, and there is no clear and unified regulatory landscape providing rules of the road for token issuers on a global scale. This lack of regulatory uniformity creates risks for issuers, who must stay in compliance with regulations wherever their tokens are marketed and sold, and for investors, who may fear scams, fraud, or legal liability in an unregulated market.

Until comprehensive legislation is adopted, the legal and regulatory architecture applicable to the tokenization of real estate assets is governed by a patchwork of existing laws and regulations as construed by courts. Against that backdrop, the following are several key legal issues participants in the tokenized real estate space should consider.

Securities Law

Certain real estate tokens may be considered securities, requiring issuers to comply with existing securities regulations in relevant jurisdictions where tokens are offered and sold. In the US, the prevailing test for determining whether an investment constitutes a security is the Howey Test, which asks if there is an "investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others." To avoid demanding Securities and Exchange Commission (SEC) registration requirements necessary for securities offerings, token issuers in the US often avail themselves of a registration exemption under the Securities Act of 1933.

■ **Regulation D 506(c):** Frequently used for real estate token offerings, Reg D 506(c) allows for broad marketing of securities by an issuer in the US, as long as the sale of securities is limited to accredited investors who meet certain expertise or income standards.² The issuer must take reasonable steps to verify that purchasers are accredited investors, which is often accomplished through forms completed when establishing an account on the token issuer's online platform. The issuer must also file a notice informing the SEC of the offering. Qualified purchasers receive "restricted securities" that are subject to certain transfer restrictions ranging from six months to one year.

■ **Regulation CF:** Reg CF is a "crowdfunding" exemption that requires an issuer to sell securities online through a broker-dealer platform or registered funding portal. The offer and sale of securities to unaccredited investors is permitted, subject to

2. "Accredited Investor," US Securities and Exchange Commission, modified April 28, 2022.

varied limitations based on annual income or net worth. This exemption may be useful for only smaller scale real estate token projects because the issuer is limited to a \$5 million fundraise across all its Reg CF offerings over a 12-month period. The issuer is required to file certain disclosures to the SEC, investors, and the intermediary that facilitates the offering on an ongoing basis. Securities purchased in a crowdfunding transaction generally cannot be resold by investors for one year.

■ **Regulation A+:** Also known as a “mini IPO,” Reg A+ allows an issuer to broadly market its offering to the public, and the tokens are freely tradable. Reg A+ provides two offering tiers with varying requirements. Under tier 1, a company can raise up to \$20 million in a 12-month period, and sales to unaccredited investors are permitted, but the offering must satisfy state securities law requirements in every state where the tokens are offered or sold. Under tier 2, a company can raise up to \$75 million in a 12-month period. The company must file audited financials and is subject to ongoing SEC reporting, but the offering is exempt from state securities law requirements. Sale to an unaccredited investor is permitted under tier 2, capped at 10% of the unaccredited investor’s annual gross income or net worth. Despite having higher reporting requirements, tier 2 is more commonly relied on because state-by-state approval under tier 1 tends to be more expensive and time consuming.

■ **Regulation S:** Reg S provides a safe harbor from registration that allows issuers to sell securities to non-US persons, subject to certain transfer restrictions. To qualify for this safe harbor, the offer and sale must occur in an “offshore transaction” where the buyer is, or is reasonably believed to be, located outside the US, and there are no selling efforts directed at investors in the US. Reg S can be used concurrently with a Reg D 506(c) offering, where the securities are sold to both non-US people and accredited investors in the US in separate, distinct offerings.

Issuances that do not qualify for an exemption must register with the SEC and are subject to the reporting requirements of an IPO.



Additional US securities laws may apply where the tokens involve participation in an investment company and/or where a performance fee may be charged to investors.

Tax Implications

Taxes provide another layer of nuance for real estate token issuers and investors. The Internal Revenue Service (IRS) has yet to provide formal guidance regarding real estate tokens. However, the IRS has indicated that virtual currency is treated as property for federal income tax purposes.³ Similarly, depending on the structure, investors may be subject to property taxes on their real estate tokens. Many other digital assets and cryptocurrencies are currently subject to capital gains taxes in the US, but lawmakers have not formally addressed taxes for security tokens. In the hands of a non-US investor, the token would likely be treated as a US real property interest, resulting in any gain from it being treated as effectively connected with a US trade or business and taxed as such if the underlying property is located in the US. To avoid responsibility for tax withholding on the amount paid for such tokens, purchasers would generally be required to obtain tax forms from the sellers demonstrating their US status.

Whether the token is an interest in the property or an entity owning the property will also have varying tax consequences for investors. In the context of a token that represents ownership in a property, transfer tax likely applies as it would in traditional real property transactions. Whether the IRS will allow real estate tokens to be used in 1031 exchanges is yet to be seen. Issuers and investors should consider the structure of the investment, the location of the property, and the types of revenue generated.

Anti-Money Laundering (AML) and Know-Your-Customer (KYC) Requirements

Best practice for real estate token issuers is to ensure compliance with AML and KYC requirements, which are designed to prevent criminals from transacting in funds that come from illicit activities, as well as to

prevent fraud. Generally, KYC in this context refers to the process of taking reasonable steps to gather information from potential investors and conducting due diligence to verify their identities. AML processes may include reporting suspicious activity and ensuring adequate recordkeeping. To aid in this process, token issuers can utilize smart contracts that automatically maintain a list of approved investors and prevent unverified investors from obtaining the tokens. Token issuers can also utilize blockchain records to monitor for suspicious transactions.

Conclusion

Tokenization offers potential benefits to the real estate market, but many technical and legal obstacles must still be considered. For instance, documents must be prepared so that the tokens validly represent the intended interest. Real estate transactions themselves are highly complex, and contractual terms such as exit rights, transfer restrictions, holding periods, capital contributions, change of control, and management obligations are heavily negotiated. Further, financing on a property may carry similar restrictions that must be accounted for. Thus, when structuring a real estate tokenization project or considering an investment, it is critical to consult with attorneys with deep knowledge and experience in both real estate and emerging technologies. ■

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3. [Frequently Asked Questions on Virtual Currency Transactions](#), IRS, Updated March 23, 2022.