

Tokenization of Real Estate: What, Why and How

September 1, 2020 | By: Max Dilendorf, Esq., Rika Khurdayan, Esq. And Gleb Zaslavsky, Esq.

You can also [download this article in PDF format here](#).

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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).

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

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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, and more.

The types of real property involved can also vary widely, including single-family homes, multifamily structures, office buildings, warehouses, retail spaces, and everything in between. According to Bari Zahn, Dilendorf's special international tax counsel, the flexibility of real estate tokenizations to diverse asset classes, coupled with non-US investor demand requires careful cross-border planning to ensure the tax-efficient holding of such U.S. investments.

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.

Liquidity

Chief among the advantages of tokenization is liquidity. Liquidity refers to the ease with which an asset can be bought or sold.

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al-estate tokens combine to make such an improvement possible:

Global investment pool. With tokenization, the pool of potential investors is truly global. Anyone with sufficient capital and an internet connection can easily participate in buying, holding, and selling real estate located anywhere in the world

Reduced cost of entry. What counts as “sufficient capital” will also change when real estate is tokenized. A virtual token does not necessarily have to be sold as a whole unit. Instead, the code underlying the token may permit it to be subdivided, allowing the issuer or subsequent holders to sell fractional tokens at lower prices due to fractionalization. This opens the market to smaller investors who could not otherwise participate and enables greater opportunities for diversification for wealthier investors.

Standardized transactions. Thanks to the blockchain technology on which tokenization is built, the purchase and sale of real-estate tokens can be implemented using standardized smart contracts, which do not have to be individually negotiated, and the terms of which are implemented automatically, reducing transaction costs substantially.

Other Advantages of Tokenization

Tokenized real estate will also provide additional advantages to investors and issuers, such as:

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.

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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

Legal Entity

Smart Contracts

Securities Regulations

Corporate Code (including other entity types)

Tax and Reporting Considerations

Asset Type

Location

Tokenization Ratio

Mortgage Issues

Tracking Tokenholders

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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.

In contrast, tokenized debt may be subject to the special regulations regarding asset-backed securities, which are securities primarily serviced by the cash flows of a discrete pool of receivables or other financial assets.

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

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Are distributions mandatory or discretionary?

How will the amount of distributions be determined?

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 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.

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onal 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?

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.

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.

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

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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.

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.

Resources

Tech's Effect on Real Estate

Tokenized Security & Commercial Real Estate

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[Better Regarding Real Estate Tokenization to Wyoming Blockchain Legislative](#)

[Real Estate, Vehicles, and Parts, Insurance on Blockchain](#)

[SEC Offering Statement for Real Estate Tokenization Project – PropertyClub, Inc](#)

[Tokenization of Assets is Disrupting the Financial Industry](#)

[Token Taxonomy Act of 2019](#)

[Regulatory Approaches to Cryptoassets – Library of Congress](#)

[Real Estate Digitization](#)

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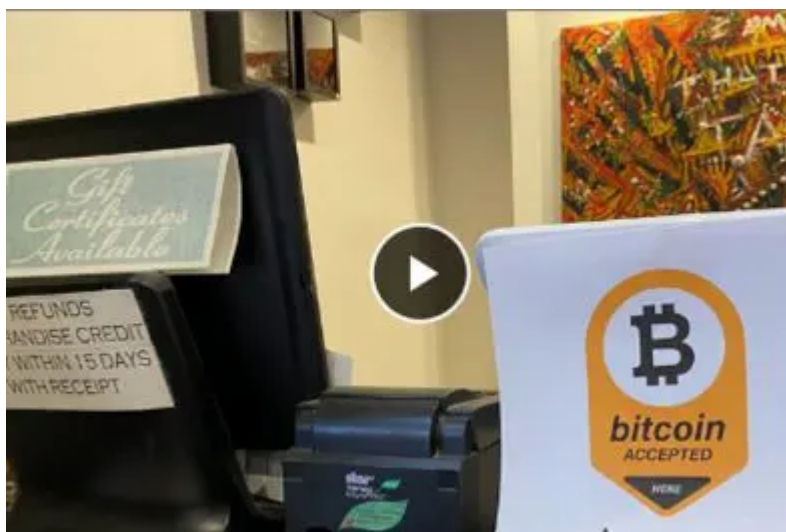
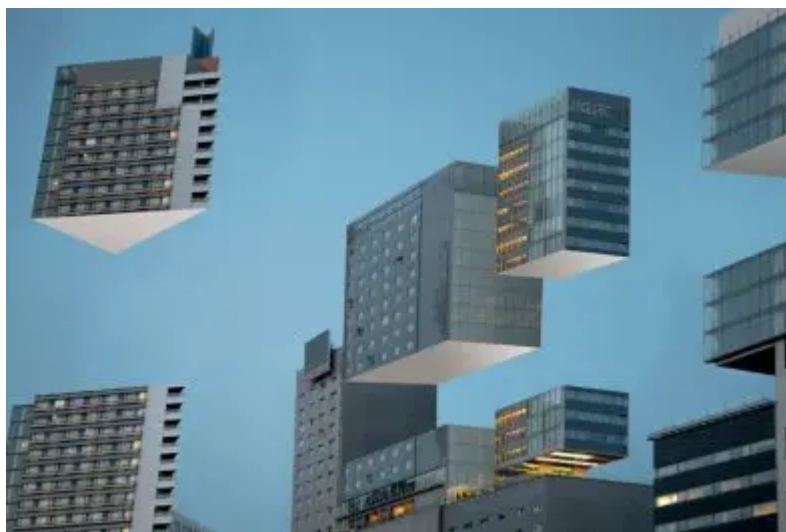
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