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Tokenization of Real Estate: Revolutionizing Real Estate through Digitalization and Reduced Market Barriers

Published on December 29, 2021 — in Investment/Real Estate/Technology/Volume IV

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In an era of growing digitalization of markets, real estate is no exception. Since 2016, digitalizing real estate investments into tradeable tokens has revolutionized the industry by broadening market participation, automating middleman processes, increasing liquidity, and improving transparency. This article explores what tokenization is, how it works, its advantages and challenges, and how it compares to Real Estate Investment Trusts ("REITs").

Background

The traditional global real estate market is one of the largest markets on earth – valued at a whopping $280 trillion.[1] Despite its impressive market size, traditional real estate is often critiqued as one of the most illiquid and nontransparent markets because of high investment costs, inefficient processes, expensive middlemen, and market conditions that tie investments for a long time. Tokenization addresses the drawbacks of traditional real estate by reducing market barriers, increasing liquidity, improving transparency, and streamlining processes.[2]

To understand tokenization, we must first understand blockchain. The blockchain network is a decentralized database that stores information like a digital ledger – irreversibly tracking and listing every transaction on a token.[3] Blockchain is nearly impossible to change, hack, or cheat because it is embedded with smart contracts that permanently record transactions and make them viewable to anyone.[4] Real estate tokenization is the process of fractionalizing or breaking down property into tokens stored on a blockchain. Investors can secure direct ownership in a piece of the underlying, tangible asset without buying or managing the property themselves – management duties primarily lie with property developers and managers.[5]

According to a recent study by the international advisory and accountancy network Moore Global, ". . . even if just 0.5% of the total global property market were to be tokenized in the next five years, it would be on track to become a $1.4 trillion market." [6] In other words, even if only a small portion of traditional real estate were to be digitalized, investors would still tap into a significant investment pool. As with most emerging markets, tokenization poses several obstacles due to its novelty and uncertainties associated with taxation, regulation, and governance – further discussed in the "Challenges" section below.[7]

How Does Tokenization Work?

There are three main phases of tokenization:

Phase 1 – Deal Structuring and Shareholders

Property owners decide the type of asset they wish to digitalize – they could either form a Special Purpose Vehicle (SPV), a subsidiary created by a parent company to isolate financial risk, or become part of a Real Estate Fund or a REIT, which are funds that invest in real estate securities. Shareholders may have various rights to dividends, equity shares, and partial governance depending on the asset's location, expected funding, taxation structure, and type of investor.[8] It is still unclear exactly what rights shareholders have with tokenized real estate because of the uncertainties associated with the novel investment's governance, tax structure, and regulatory framework.[9]

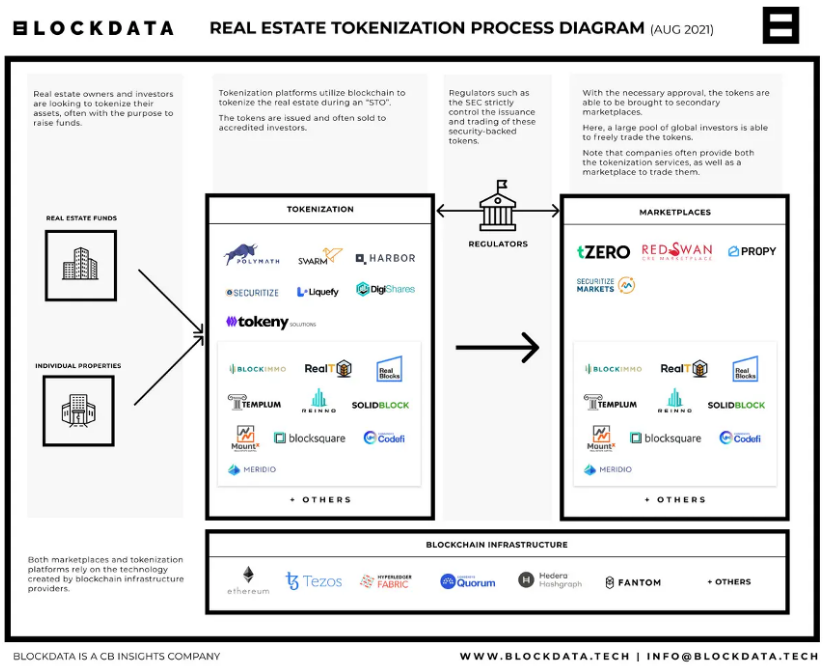
Phase 2 – Selecting Tokenization Platform

Property owners then choose from a range of platforms that create tokens. Tokenization platforms use blockchain technology to generate automated agreements highlighting transaction terms between buyers and sellers. These "smart contracts" are essentially codified rules and behaviors that follow the token throughout its lifecycle. Smart contracts are the bedrock of blockchain, and the reason blockchain is nearly impossible to change, hack, or cheat.[10]

Phase 3 – Issuance, Regulation, and Distribution

During the Security Token Offering (STO), digital tokens are created and issued on blockchain in the form of regulated assets – like stocks issued on the stock market during an Initial Public Offering.[11] Token issuance and distribution must meet certain regulatory standards, but the regulatory framework is still uncertain because tokenized real estate is a relatively new field. For example, whereas some regulators – like the U.S. Securities and Exchange Commission (SEC) – treat real estate tokens as securities, others categorize the tokens as property. [12] Categorization affects the asset's tax and regulation structure, so the failure to assign a definitive asset class to real estate tokens creates uncertainties, discouraging investment.

Once regulation standards are met, global investors freely trade the tokens in a secondary marketplace.[13] The chart below lists several secondary platforms for trading real estate tokens.



[14]

Advantages of Tokenization

Low Entry Barriers

Only 3% of the global population has invested in real estate, but over 80% view real estate as a good investment.[15] By reducing upfront investment costs, streamlining processes, and increasing transparency and liquidity, tokenization addresses the drawback of traditional real estate associated with high upfront investment costs and inefficient processes involving expensive intermediaries, paper documentation, and loan qualifications.[16]

Tokenization uses fractionalization to reduce the high costs of traditional real estate. While investors purchase an entire property with traditional real estate, tokenization allows everyday people to invest in smaller portions of the same property, thereby increasing accessibility to investment with lower costs. In 2019, a €6.5 million luxury villa in Paris was tokenized and split into 1 million pieces, valued as low as €6.5 each. Tokenization drastically reduced the investment cost, which increased accessibility to a broader range of investors. [17] Moreover, tokenization reduces procedural barriers through digitalization. Whereas traditional real estate is limited mainly to regional investors during local opening hours, real estate tokens can be traded at any time across borders.[18]

Diversification

With low costs and a virtually open global market, investors can create highly diversified portfolios. They can purchase shares of malls, movie theatres, and apartment complexes with ease.[19]

Liquidity

Whereas traditional real estate investment requires locking in capital for an extended period, digital tokens can be securely and efficiently transferred on a blockchain network. Thus, tokenization increases liquidity by making trading cheaper, faster, and easier.[20]

Efficiency

Tokenization is cheaper and more efficient because blockchain technology automates processes and cuts out middlemen. For example, tokenization does not involve agents and brokers who act as middlemen to real estate transactions. Accordingly, real estate tokens are cheaper because they do not capture the costs associated with lengthy document reviews and layered communication. Alternatively, the smart contracts on blockchain's unalterable framework drive down fees and costs associated with traditional real estate.[21]

Transparency

Transparency is a huge selling point of tokenization. Blockchains essentially operate as public ledgers, recording every transaction involving the token. These recorded transactions are unalterable and can be viewed by anyone at any time, which increases security and transparency. It is more difficult to obtain records of every transaction involving a traditional real estate property.[22]

Additional Capital

Developers can tap into more capital at any stage of development through tokenization. By efficiently fractionalizing properties and reducing market barriers, developers facilitate greater market participation, which increases capital inflow.[23]

Challenges to Tokenization

Regulations

Uncertainty about regulation poses the most significant hurdle to real estate tokenization. Because tokenization is a relatively new investment form, regulators have yet to establish a clear and consistent framework to follow. While some regulators view real estate tokens as securities, others categorize them as real property investments. For example, the SEC categorizes most tokens as securities, the Commodity Futures Trading Commission considers some tokens to be commodities, the U.S. Department of the Treasury's Financial Crimes Enforcement Network categorizes some tokens as currencies, and the Internal Revenue Service considers some tokens to be taxable property. Additionally, there is no international regulatory framework to reference.[24] The inconsistency among regulators about how to categorize real estate tokens leads to unclear rules and confusing processes – both of which deter potential investors and threaten the long-term viability of tokenization.

Addressing regulatory uncertainties is of utmost importance to adopt tokenization on a larger scale. Accordingly, there is a growing consensus on the need for the development of a well-defined regulatory system for real estate tokens.[25] Recent SEC developments sent a strong message of heightened scrutiny and regulations for intermediary platforms, which are similar to the secondary platforms associated with trading real estate tokens. In September 2021, the SEC targeted a crowdfunding portal because it allowed its investors to be scammed. The SEC said it considers crowdfunding portals to be "gatekeepers" and expects these intermediaries to thoroughly vet fundraising efforts or face repercussions.[26] Stricter regulations of secondary marketplaces would likely deter investors from trading real estate tokens.

Lack of Public Awareness

The lack of public awareness of real estate tokenization poses another obstacle to adoption. Despite cryptocurrencies drawing much attention from the public in recent years, real estate tokenization remains largely unknown. The lack of public awareness may be attributed to minimal market participation by sophisticated parties like large real estate companies and investors. However, publicizing large-scale real estate token transactions demonstrates the advantages of tokenized real estate that could likely address this problem.[27]

Volatility

Finally, the general volatility surrounding blockchain-based systems leads to hesitancy with investing.[28] First, as an emerging market using developing technology, cryptocurrency has been a highly volatile investment.[29] Second, the cryptocurrency market thrives on investors making speculative bets that prices will go up or down to make profits – these bets lead to sudden market influxes and crashes.[30] Third, most cryptocurrencies experience fluctuations because they are purely digital assets with no backing of physical commodities. However, real estate tokens are less susceptible to volatility because they are backed by physical properties.[31]

Tokenization v REITs

REITs revolutionized the United States real estate market in the 1960s by introducing fractional real estate ownership. REITs are companies that own and operate portfolios of diverse real estate assets. Like tokenization, REITs reduce market barriers by streamlining trading through technology, reducing upfront investment costs, and increasing diversification.[32]

Unlike tokenization, REITs operate under a well-defined regulatory system and provide a tax-efficient structure because they are pass-through entities that are not subject to corporate income tax. While REITs are regulated as securities, it is unclear whether real estate tokens will be regulated as securities or property. Additionally, while REITs are restricted by investment minimums and historically give low returns, real estate tokens are open to anyone and mostly have no minimum investment. Finally, whereas REITs provide an option to invest in various real estate assets, tokenized real estate provides an option for a more specific investment linked to a property.[33]

St. Regis Tokenization Case

The St. Regis Aspen Resort case demonstrates the relationship between REITs and real estate tokens. In 2018, resort owner Elevated Returns decided to offer its hotel ownership through token sales.[34] Elevated Returns created SEC-compliant Aspen Coins (tokens) priced at $1 per coin. Elevated Returns completed one of the first successful real estate offerings for $18 million on the Ethereum blockchain. Through the secure and transparent blockchain technology, Elevated Returns took a physical asset – the St. Regis resort – and sold it in many pieces as tokens. This deal incorporated the best attributes of REITs and real estate tokens. The REIT structure made the token subject to securities regulations, while the blockchain technology provided a sophisticated smart contract for simplified peer-to-peer investing across borders.[35]

Conclusion

Real estate tokenization has the potential to revolutionize the way people invest in real estate. In theory, tokenization significantly increases the pool of investors who have access to real estate investments. By using sophisticated blockchain technology and fractionalization, tokenized real estate reduces costs and encourages diversification.

Nonetheless, tokenization must overcome several hurdles to reach its full potential—namely, the regulatory uncertainties and volatility associated with digital real estate tokens. Several legal and practical issues could dictate the success of tokenization. Accordingly, property owners should consult knowledgeable legal, securities, tax, accounting, and real estate professionals during the early stages of tokenization to minimize the risks and costs associated with navigating the novelty investment.

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[12] *Id.*

[13] *Id*.

[14] Max Bijkerk, Tokenized real estate: 2021 update. BLOCKDATA TECH (Sep. 27, 2021), https://www.blockdata.tech/blog/general/tokenized-real-estate-2021-update.

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[17] Bijkerk, supra note 16.

[18] Won, *supra* note 21.

[19] Bijkerk, supra note 24.

[20] *Id.*

[21]*Id.*

[22] Jane, *supra* note 5.

[23] *Id.*

[24] Morton, *supra* note 20.

[25] *Id.*

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[28] Jane, *supra* note 29.

[29] NDTV Business Desk, *What Makes The Cryptocurrency Market So Volatile? Find Out*, NDTV Profit (Aug. 14, 2021), https://www.ndtv.com/business/why-is-the-cryptocurrency-market-so-volatile-2509836

[30] *Id.*

[31] *Id.*

[32] Bijkerk, *supra* note 20.

[33] Morton, *supra* note 34.

[34] Won, *supra* note 25.

[35] *Id.*