

Will the Proposed IRS Regulations Hinder the Growth of Tokenization in Real Estate?

In the Dirt: A Real Estate Legal Update

By Joseph Tierney IV on October 3, 2023

As digital currency grows in use and acceptability, digital currency has entered into many traditional investment markets. Commercial real estate is no exception.

The conversion of real estate assets to digital tokens using blockchain technology ("tokenization") is continuing to grow, with a market size of approximately \$200 million, real estate tokens account for nearly 40% of the digital securities market.

Tokenization is attractive because it allows for digital ownership of real estate, fractional shares, and speedy transfer of property.

What is Virtual Currency?

Virtual currency is defined in Notice 2014-21, 2014-16 I.R.B. 938 (April 14, 2014) (Notice 2014-21 or Notice), for Federal income tax purposes as a digital representation of value that functions as a medium of exchange, a unit of account, or a store of value other than the U.S. dollar or a foreign currency (fiat currency).

The Notice provides that convertible virtual currency (that is, virtual currency that has an equivalent value in real currency or that acts as a substitute for real currency) is treated as property for Federal income tax purposes.

Digital Assets and Proposed Regulation Changes

In November of 2021, the Infrastructure Investment and Jobs Act expanded Section 6045 of the Internal Revenue Code to require the reporting of certain transactions involving the sale or exchange of digital assets.

On August 25, 2023, the Treasury Department promulgated over 280 pages of proposed regulations. Those proposed regulations define a digital asset as "any digital representation of value that is recorded on a cryptographically secured distributed ledger."

Since real estate tokens pretty clearly meet the definition of a digital asset, they will be subject to any final regulations. It is important to note that these are not *final* regulations and that the comment process is still open with public hearings scheduled for November 7th and 8th.

However, a look at the proposed regulations as they apply to the tokenization of real estate leads to some interesting observations.

PRIVACY AND SECURITY

In an effort to address the practical anonymity of these transactions, the information reporting requirements appear to substantially exceed that information required of a taxpayer in a traditional real estate transaction.

This may change based on public comment, but the scope of the information required (wallet addresses, blockchain transaction identifications, type of consideration, etc.) raises privacy concerns that are less present in a traditional real estate transaction where actual accounts are not disclosed.

TRANSACTION COSTS

If the proposed regulations continue in their broad effect, there is concern that the practical security and privacy efforts will result in additional transaction costs that offset the natural advantage of digital transactions.

In other words, the cost of the efforts to comply with the regulations while protecting the privacy and security of the parties will exceed the benefits of tokenizing the real estate.

BROKERS

The definition of “broker” under the proposed regulations is broad and might include real estate brokers. Under the proposed regulations, the “broker” has to report gross income and cost basis in the same manner as a securities broker.

Treasury is even discussing a new Form 1099-DA. If a traditional real estate broker is going to participate in the sale of tokenized real estate, they now potentially face a different type of compliance issue. Thus, the regulations could further split the real market into digital and non-digital by raising barriers to entry for the traditional real estate broker.

REAL ESTATE REPORTING

The proposed regulations also complicate and expand the reporting of real estate transactions.

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Proposed Regulation § 1.6045-1(a)(1) was also modified to provide that “a real estate reporting person” is a broker with respect to digital assets used as consideration in a real estate transaction if the reporting person would be required to make an information return with respect to that real estate transaction under proposed § 1.6045-4(a), without regard to any reporting exceptions provided under section 6045(e)(5) or proposed or existing § 1.6045-4 (c) or (d), such as the exception for certain sales of principal residences or the exception for exempt real estate sellers.

Thus, for example, a real estate reporting person would be required to report on a real estate buyer's exchange of digital assets for real estate as a sale of those digital assets even though the real estate reporting person is not required to report on the real estate seller's exchange of the real estate for digital assets due to the fact that the seller of that real estate is an exempt seller, such as a corporation, under existing § 1.6045-4(d).”

Brokers, title companies, and the entire traditional HUD list should be on notice.

It will be interesting to see how this plays out and develops. Tokenization of real estate is likely to grow as the varying rules across jurisdictions crystallize and become more consistent. However, adding broad regulations on top of the challenges still faced in conveyancing and record keeping from a digital perspective may slow this growth.

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