December 2021

HOT TOPIC ALERT

Crowdfunding in Real Estate

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"Crowdfunding" as a business model has become increasingly popular in recent years. With crowdfunded projects, traditional lending sources are bypassed, allowing individual investors to directly evaluate a proposal based on their own criteria or financial interests. The system has populist appeal: in theory, crowdfunding enables those who would otherwise be denied access to capital to move forward with a crowdfunded platform and expands investment options for contributors.

In this Hot Topic Alert, we look at crowdfunding in the real estate marketplace. We examine the definition of crowdfunding, and consider some of the legal and regulatory ramifications surrounding it. We also examine some case studies of successful crowdfunded real estate projects

NATIONAL ASSOCIATION OF REALTORS®

What is "Crowdfunding?"

"Crowdfunding" refers to the practice of using a third party, known as a platform, to solicit financial contributions from a large number of people. This type of fundraising commonly occurs online with the platform retaining a portion of the funds collected as a fee. Kickstarter, GoFundMe, and Indiegogo are among the more popular crowdfunding platforms currently in use. Crowdfunding is popular among artists, inventors, consumer product developers and entrepreneurs seeking financial support for their projects. Even independent bookstores have turned to crowdfunding to keep their businesses operating in the face of much bigger competition, or during difficult economic times.

There are four main types of crowdfunding:

1. Donation based, in which donations are solicited without anything offered or expected in return. GoFundMe is an example of this type of crowdfunding.

2. Rewards based, in which a contributor receives a varying level of reward, according to the amount contributed. The reward might be a product that will be produced in the future using crowdfunding capital. Patreon uses this model.

3. Debt based, in which the investments are loans to be repaid with interest. Debt based crowdfunding is used by many start-ups. Lending Club is an example of this type of model.

4. Equity based, in which the investor receives a stake of the company that is soliciting funds. An example of this type of platform is Angellist.

Inevitably, crowdfunding has grown to encompass real estate finance. The idea has spread quickly: one estimate is that there are currently over 100 real estate crowdfunding platforms, such as Fundrise and Crowdstreet, for investors to choose from. Enthusiasts claim that crowdfunding has brought benefits not only for investors but also for real estate companies and for the real estate market as a whole.

Proponents claim that crowdfunding opens up the real estate investment market. Potential investors can locate and research multiple investment opportunities on their own. Sometimes, investors are motivated to invest in projects within their community or products they personally believe will succeed. In addition, crowdfunding investment solicitations are often directed towards individuals without a high net worth or large disposable income. Those investors are attracted by the low minimum investment requirements, and the low fees charged by intermediaries. Many real estate crowdfunding platforms allow participants to invest as little as $1,000, and Fundrise requires a minimum investment of only $100. Since May of 2016, participation in real estate crowdfunding has been opened to non-accredited investors, defined as individuals who do not have a net worth of more than $1 million, or who have not earned an annual income of $200,000 (or $300,000 joint income for a married couple) for the past three years.

Are Crowdfunding Offerings Securities?

Crowdfunding campaigns look a lot like public offerings of securities. Shares or other financial instruments are offered for sale to the public in order to raise funds for a company or venture. Public offerings must be registered and approved by the Securities and Exchange Commission (SEC). This raises an important question: Is SEC registration required for a crowdfunding campaign?

Real estate crowdfunding has its origin in the "Jumpstart Our Business Startups Act," enacted by Congress in 2012. That law, popularly known as the JOBS Act, is an effort to promote small business growth by easing some securities regulations. In particular, Title III of the Act (also referred to as "Regulation Crowdfunding" or "Reg CF") contains provisions designed to encourage crowdfunding by exempting it from some securities laws.

Pursuant to the terms of Reg CF (as amended in November 2020), crowdfunded investments may be offered only through licensed broker-dealers or registered investment portals or platforms. These portals are regulated, but the regulations reflect the more limited role the platforms play. Platforms do not provide investment advice, for example. Also, while crowdfunding investments must still be registered with the SEC, the information and paperwork required for such a registration is less than what would be required for a typical registration of a public offering, and a crowdfunding campaign is exempt from the registration requirement if no more than $5 million is raised in any one year.

There is no limit on the amount that accredited investors may invest in crowdfunding platforms. However, aggregate annual investments by non-accredited investors are capped at the lesser of $2,200 or 5% of the individual's net income or net worth (if the investor's annual income or net worth is less than $107,000), or 10% of the individual's annual income or net worth (if both the income and net worth of the investor exceed $107,000).

When adopted, the terms of Reg CF required SEC staff to "undertake to study and submit a report to the Commission no later than three years following the effective date of Regulation Crowdfunding on the impact of the regulation on capital formation and investor protection." This "Report to the Commission," dated June 18, 2019, found that the number of crowdfunding offerings as well as the total amount of funding was, as of the date of the report, relatively modest, although the market exhibited growth over time. The typical offering was small: the median target amount sought was $25,000 and the median maximum amount sought was $500,000. Most of the issuers that sought financing under Regulation Crowdfunding were relatively small and early in their lifecycle.

Other Federal Laws

One of the disadvantages of crowdfunded investments – at least, from the standpoint of the investor – is the limited opportunity to sell the investor's interest. Federal regulations provide that securities purchased in a crowdfunding transaction generally cannot be resold for a period of one year after acquiring the intertest. Exceptions to the general rule allow transfer to the issuer of the securities, to an "accredited investor," or as part of an offering registered with the SEC. An "accredited investor" is defined as a bank, a private business development company, a tax-exempt charitable organization with total assets of more than $5 million, an officer, director, or general partner of the entity issuing the securities, or an individual with a net worth of more than $1 million. Transfers are also allowed within one year of acquisition if the transfer is to a member of the purchaser's family, to a trust controlled by the purchaser, to a trust created for the benefit of a member of the purchaser's family, or in connection with the death or divorce of the purchaser "or other similar circumstance."

Tax Issues

A crowdfunding investment will, just as any other type of investment, raise tax concerns. On June 24, 2016, the IRS issued Information Letter 2016-0036 regarding the issue of funds raised through crowdfunding. The Information Letter states that the proceeds received through crowdfunding are reportable to the IRS as income in the year they are received, or the year in which they are "constructively available" to the taxpayer. However, if the investor receives no reward, some receipts may be eligible for treatment as nontaxable contributions to capital by a non-shareholder. Most reward based crowdfunding campaigns will not qualify for this tax treatment as most creators do not operate their campaigns through corporations.

State Laws and Regulations

All 50 states, the District of Columbia, and most U.S. territories have their own securities laws and rules aimed at protecting investors from securities fraud. These laws are commonly known as "Blue Sky Laws," so called because they were aimed at protecting investors from "speculative schemes which have no more basis than so many feet of blue sky." Blue Sky Laws apply to many different types of investments, and not just crowdfunding.

Typical Blue Sky Laws require that all investment brokers and advisors be licensed and that investment offerings be registered. The registration process may include a review of the offering by state agents to determine if it is balanced and fair for the buyer. Blue Sky Laws also commonly require disclosure of all the terms and financial details related to an investment offering. This disclosure allows investors and potential investors to have verifiable information when they make their investment decisions

While the specific terms of Blue Sky Laws may vary state to state, they all have the same focus; namely, protecting individuals from fraudulent or overly speculative investments. The laws also have the goal of deterring sellers from taking advantage of inexperienced or unknowledgeable investors. To that end, the laws also establish penalties for making fraudulent statements or failing to disclose information, and they allow lawsuits and other legal actions to be brought against issuers who do so.

The SEC defers to state securities regulators on the subject of intrastate sales of investment products. Thirty-four states and the District of Columbia have established intrastate exemptions to their local securities laws for crowdfunding. These exemptions allow businesses to engage in crowdfunding within a single state or territory without being subject to securities regulations intended for more established businesses. To qualify for an exemption, a business must, among other things, maintain an in-state principal place of business and must raise funds from in-state residents only.

Local Projects

Crowdfunding is often promoted as a way for smaller investors to participate in the real estate market. These investors are attracted by prospects of very low fees paid for participation, small minimum investments, and impressive annual returns. But some crowdfunding projects seek investors who have different motives.

Some crowdfunding campaigns focus on financing neighborhood rehabilitation or revitalization. Some of these efforts may be small-scale campaigns directed at saving a favorite local landmark or business. For example, in Milwaukee, a crowdfunding campaign raised funds to rehabilitate and reopen a historic restaurant building in the city's Lindsay Heights neighborhood. In addition to the restaurant, the renovated building includes office and studio space and is described as "one of several catalytic developments" in the neighborhood. Crowdfunding has also been tapped for larger, more ambitious projects, such as the redevelopment of the Detroit Tigers stadium site.

Other crowdfunding platforms combine the goal of community development or redevelopment with the profit motive. For example, a Pittsburgh-based company called Small Change selects real estate development projects that cannot get financing from traditional sources such as banks, and then rates them according to a proprietary "Change Index." This index measures factors such as mobility (access to transit, walkability, bike lanes, etc.), sustainability, and economic vitality. Potential investors are then presented with a project's index number, which they use to evaluate the investment themselves. Small Change has funded more than a dozen projects to date, including a "tiny house" in the Garfield neighborhood of Pittsburgh, an eight-unit bungalow court for the homeless in Los Angeles, and an affordable, energy efficient, forty-four unit apartment complex in Capitol Heights, MD.

Another crowdfunding platform, American Homeowner Preservation, seeks to turn a profit for investors while saving homeowners from foreclosure. AHP buys pools of distressed mortgages at a deep discount then, rather than foreclosing, AHP works with the homeowners to modify the loan terms. If the effort is successful and the loan starts performing, AHP bundles the mortgages and sells them as re-performing loans. The homeowners get to keep their house, the new buyers get a high-quality loan, and AHP investors earn a profit. If AHP is unable to help a borrower modify their mortgage to make it affordable, AHP forecloses and sells the property.

While there are many non-profit and community groups using crowdfunding for development projects, whether the number of for profit real estate focused platforms continues to grow depends on a number of factors, including whether investors really can do well by doing good.

Pros and Cons of Crowdfunding

From the perspective of a fundraiser, crowdfunding offers the benefit of accessing a broader network of capital sources. Anyone over the age of 18 with as little as $100 to invest is a potential contributor. Also, if the project raises less than $5 million in a year, it may qualify for an exemption from securities regulations.

For investors, access to crowdfunding portals and low minimum investment requirements provide opportunities for greater geographic and financial diversification of their investments than they might otherwise have had. With crowdfunding, the investor can realize a return without being required to participate in managing the project, however, this also means that the investor has no control over how their contribution is handled. If an investor becomes dissatisfied and wants to get rid of an asset, the process for doing so may not be as simple as it would be with other investments. As previously stated, SEC rules on crowdfunding limit the resale of crowdfunded investment shares to the issuer, an accredited investor, as a part of an offering registered with the SEC, or to a member of the investor's family for a period of one year after purchase.

The SEC also cautions that resale may be difficult because a seller may have to locate a buyer for the crowdfunded investment him or herself. Unlike traditional securities, crowdfunded investments have no exchange on which they are traded. The new and different character of crowdfunding may make buyers hesitant to repurchase shares at any price, particularly if the seller is selling them because performance has been a disappointment. A willing seller may very well be stuck with an unwanted investment. Therefore, non-accredited investors must understand the potential risks associated with crowdfunding investments.

REALTOR® Associations

The National Association of REALTORS® and state and local REALTOR® associations have no policies or positions specific to crowdfunding in the real estate market. As always, we continue to support laws and regulations that ensure that there is an adequate flow of capital to finance real estate development, rehabilitation and other projects.

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