nerej CELEBRATING 55 YEARS

# Will crowdfunding disrupt real estate capital markets?

March 19, 2015 - Construction Design & Engineering

Years back, a lot of speculation surrounded how the retail real estate market would be impacted when the World Wide Web and e-commerce emerged. Although companies like Amazon have dramatically changed the way we shop, the US e-commerce sales as a percentage of retail sales only amounted to 6.40% for Q2 2014 according to the U.S. Census Bureau. Thus, the real estate market has not been as disrupted by e-commerce as anticipated. Much to the satisfaction of real estate owners and operators, brick and mortar retail is continuously showing signs of improvement. The popularity of real estate as an investment vehicle combined with certain legislative changes such as the Jumpstart Our Business Startups (JOBS) Act in 2012, have created a new opportunity in the real estate capital markets: real estate crowdfunding.

Ins and Outs of Crowdfunding in Real Estate

Real estate crowdfunding aims to allow anyone who has a minimum of $1,000 or so to invest in real estate projects that can be selected within a list of offerings through an online investment platform. Different from most other common real estate investment models such as REITs, the concept of real estate crowdfunding offers transparency as to which assets the funds are invested in. Furthermore, by cutting out the middleman, fees can be significantly lower than REITs or other similar funds.

So how does real estate crowdfunding work in more detail? The first step is for a potential investor to search for a real estate crowdfunding online platform and register by creating an investor profile. Once registered, the investor has access to a listing of properties that actively seek funding. Depending on what type of return the investor is seeking, - fixed income or capital appreciation - properties can be funded via debt, equity or both. After carefully selecting the project to invest in, the investor will advance the funds. The cash will be kept in an escrow by the syndicator until the acquisition is completed. All funds will be refunded to the investor in the event an agreement is not reached. Investment maturities range between 1 to 5 years. The crowdfunding portal is responsible for the due diligence, legal and management aspect of the deal in return of a fee, usually 1%-2% for debt and 3%-4% for equity.

Non-Accredited Investors Await Changes to Participate

While real estate crowdfunding's primary goal is to expand the real estate investor base by giving more individuals an opportunity to invest directly in real estate, this is not quite currently the reality. Current regulations allow only accredited investors, - individuals with annual income greater than $200,000 and net worth greater than $1,000,000 - , to invest in the majority of these deals. Until the SEC issues final rules implementing Title III of the JOBS Act allowing non-accredited investors to participate in crowdfunding, the percentage of the population that can actually invest in these types of deal is limited. In addition the real estate is not directly owned by the investor. Commonly the real estate is owned by an LLC and the investors are members of the LLC. As with any other investment choice, investing in real estate crowdfunding presents many tax implications at the federal and state tax level. The investor will typically receive a Schedule K-1 to report its share of income or loss in the LLC. Depending on which state the real estate project is located in the investor might have filing responsibilities and potentially tax liabilities in that state. It is important for the investor to fully understand how the investment will be structured and its tax implications.

Real estate crowdfunding is still in an early stage and it will be interesting to see how it will evolve. While we don't expect real estate crowdfunding to be disruptive to the real estate capital markets, it should be acknowledged as a new source of capital that will complement the more established and known sources.

Donald Greenhalgh, CPA, is a partner in the real estate practice group at DiCicco, Gulman & Co., Woburn, MA.