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LEGAL ISSUES AROUND NFTs & THEIR WAYS OUT

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ABSTRACT

With the fastest growing demand for Bitcoin currency, the concept of NFT is essentially a new one. It is, however, a lesser-known issue, despite the fact that it has shown to be incredibly profitable. By allowing users to construct and build new kinds of ownership, NFT enables new markets to emerge. Non-fungible tokens are being purchased for tens of thousands or even millions of dollars. The NFT market saw trading volume of \$25 billion in only 2021. Large quantities of money are frequently accompanied by fraud and scams. Digital assets' rising prominence has given rise to a number of legal issues. The lack of a developed NFT regulatory framework is the fundamental issue. There is still disagreement about how to handle NFTs, which makes it difficult to set clear regulatory norms. NFTs can now be seen in one of three ways: as goods, securities, or intellectual property. Each view is covered in further detail throughout the article. These digital assets were not intended to be supported by NFT standards or the legal system. However, even as NFT investors, buyers, and sellers investigate this area, new NFT legal difficulties keep cropping up. Still, it is appropriate to say that the NFT market is still developing, and it will take time for a proper NFT legal framework to be established. That said, governments around the world have already taken their first steps towards the creation of NFT rules and standards, demonstrating that they are paying serious attention to these digital assets. The article discusses the legal problems like Lack of Data protection regulations, Lack of intellectual property rights in NFTs, the concept of NFT faces and their possible way outs.

KEYWORDS

NFTs, Non-fungible Token, NBA, SEC, Bitcoin, CryptoPunk, Visa, Fintech, Indian Copyright Act, Section 139, Blockchain, Ethereum, LeBron James.

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INTRODUCTION

It is the year 2022, the popularity of non-fungible tokens (NFTs) and other crypto assets which represent a proof of title by providing a unique digital identity to an asset has hiked. The market of NFTs have expanded at a massive rate. In consumer goods and technology sector, fresh NFT issuances have been sold out in seconds, making their creators to earn millions.

The fastest growing concept of NFTs have the potential to facilitate new revenue pathways by establishing new forms of digital property. It acts as new channels for businesses and digital creators to reach their customers and other audiences and have enabled the way of monetizing the physical assets.

NFTs have also been issued by various businesses in various sectors, to step up the brand awareness of their quality product, utilize gaming opportunities in the virtual reality (metaverse) and to pay artists and creators for their ingenious output. Issuance of NFTs have attracted the interest of major players of the fintech sector, taking an example of *Visa*, a financial services company, recently acquired *CryptoPunk*² for nearly \$150,000 USD and hailed the acquisition as “new chapter for digital commerce³.”

The market of NFT issuances is growing rapidly all over the globe. The concept of NFTs is, however, new, and fresh. That is why the legal and regulatory treatment of NFTs is yet to form in its full manner and thus, continues to evolve.

Governments of various countries are now taking the regulation of NFTs into their consideration. Government agencies have started making the rules and laying down procedures for issuing, trading, and exchanging NFTs and imposition of tax on such transactions. Taking an example of India, government categorized the income earned from the sale of crypto and NFTs assets. Furthermore, government announced that 30%

² Ryan Browne, Visa jumps into the NFT craze, buying a ‘CryptoPunk’ for \$150,000, CNBC.COM, (September 29, 2022, 12:26 AM), <https://www.cnbc.com/2021/08/23/visa-buys-cryptopunk-nft-for-150000.html>

³ HYPEBEAST.COM, <https://hypebeast.com/2021/8/visa-enters-nfts-cryptopunk-7610-acquisition-interview> (last visited September 29, 2022)

tax will be levied on the income earned through the transfer of any virtual assets, which makes NFT to come under its ambit.

Despite recent growth and some monumental sale prices, confusion still exists about what NFTs are and the legal issues they pose.

NFTs

NFT, all about the new form of cryptocurrency in an increasingly digital world, NFTs are the latest cryptocurrencies to be all the rage these days. Highlighted by several record sales, this new form of technology which means non-fungible token is now in the spotlight. Behind this term there hides a feature that can bring thousands and even dollars to some artists and has been doing for quite some time now. If the latter have applications in the art world, the idea is that they apply equally well to the other valid fields such as video games and sports.

NFT is the abbreviation of the English term *non-fungible token*, A token is a digital asset issued by blockchain in the same category we find bitcoin. These are created on a smart contract platform, *Ethereum*. NFTs differ from other cryptocurrencies, indeed non-fungible token means that the unit or token is unique and cannot be reproduced unlike bitcoins, which are fungible. However, they are unauthorized which means anyone can create, buy or sell them without any authorization. They generally serve as evidence of ownership of virtual (and physical even) assets. Their uniqueness and ownership can be demonstrated and checked using distributed ledger technology (DLT). NFTs can be taken into use to create a valid proof of title to a unique digital asset (such as images, videos, or other digital content) or physical asset (such as paintings, sculptures or other tangible assets).

As the concept is new and fresh and is related to sensitive transactions which have no monetary limit, it is subject to various legal implications.

LEGAL IMPLICATIONS

There are several issues on the legal front that the NFTs have been facing in recent times. A lot of these legal issues are the result of inconsistencies in the local regulations and the manner in which they are being implemented within society.

As NFTs transactions reach up to millions of dollars, such situations also call for many regulations as time passes to ensure that such transactions are in no way in the threat of any other external factor or even are not misused for any other illegal personal agendas. The legal issues can be listed as follows:

- **Lack of intellectual property rights in the NFTs**

Despite the fact, that an artist may have created a particular piece of art through the application of technology, there isn't any form of intellectual property right arising from such a creation. This means that the ownership of these artworks is still in question. The NFT holders need to acquire the licenses of these pieces of art in order to reproduce the artwork themselves.

Let us take an **example** of the purchase of *LeBron James slam dunk NFT*⁴. The fact is even if you buy such NFT, the ownership of that still remains with NBA. This is not according to normal circumstance and may create legal confusion.

- **Issue pertaining to royalties**

In order to receive the royalty, raised on the sale of NFT, the platform for the re-sale should be same as was as the time when the real owner sold it on. Irrespective that the purchaser of any NFT makes a purchase on marketplace, say A and then sell it to another market, say B. The original owner will not be benefitted by any such royalties which he should deserve.

⁴ NPR.ORG, <https://www.npr.org/2021/03/09/975450173/the-200k-nba-nft> (last visited September 29, 2022)

- **Use and application of trusts**

Given the fact that the physical possession and handing over an NFT are impossible. It is important to ensure that all relevant passwords and details are kept safely for a later date.

Trusts, therefore, attract a lot of investors as it is used as an estate planning mechanism and eradicate the use of last will.

- **Taxation**

Concept of tax equally works as it is applied during normal course of income generation, the government takes a percentage of amount from such income generated as part of tax, same goes for income generated through the trade of NFTs.

But the implication is that the tax levied on the profits earned through transactions is often very high and call for a lot of payments which might discourage the user of NFT in future transactions.

- **Data protection regulations**

As NFTs are based on blockchain concept, privacy of user data is not possible. It is because every transaction is getting recorded on every set of connected networks facilitating the transaction. Hence, imposing this right becomes almost impossible through the use of blockchain.

Even the information is not used any manner, bypassing the procedure is also not a possibility. An individual NFT with private data may contradict the laws of land pertaining to privacy and hence, a lack of regulations is also noticed extensively.

- **Data hosting and information safekeeping aspect**

It is the next important concern we have as it is always recommended to make use of the blockchains while saving NFTs. Data storing violations, interruptions and the loss of important data and information is always a risk in this case.

The term *Unregistered securities* have been used a lot recently through a legal issue between *Ripple Labs v. SEC*⁵. This could also be a major issue in the NFT marketplaces.

SEC Commissioner Hester Peirce (known as “*Crypto Mom*”) categorized the fractionalized NFTs as unregistered securities and could be illegal.⁶

- **Estate and sequence planning**

It is the next important issue. The sequence of ownership in case of other properties is serious concept and has been provided in local laws of the land. However, the matter completely differs in case of NFTs. It is because regulations in this matter are not defined here and hence an inconsistency exists in this sector.

- **Anti-money laundering efforts and its impact**

The AML Act may bring a lot of essential characteristics of the NFTs⁷. The digital non-fungible token is not equal to antiquities and hence the enforcing agents may put the use of NFTs in strongly illegal activities such as money laundering and terrorist funding.

⁵ Jessica B. Magee, Scott Mascianica, Ripple Effects of Recent Discovery Decision in SEC v. Ripple Labs, Inc.?, HOLLAND & KNIGHT (September 29, 2022, 12:54 AM), <https://www.hklaw.com/en/insights/publications/2022/01/ripple-effects-of-recent-discovery-decision-in-sec-v-ripple-labs>

⁶ Sophie Kiderlin, The SEC’s ‘Crypto Mom’ Hester Peirce says selling fractionalized NFTs could be illegal, BUSINESS INSIDER (September 29, 2022), <https://markets.businessinsider.com/currencies/news/sec-crypto-mom-hester-peirce-selling-nft-fragments-illegal-2021-3-1030250153>

⁷ Will Kenton, Anti Money Laundering (AML) Definition: Its History and How It Works, INVESTOPEDIA.COM (September 29, 2022, 1:07 AM), <https://www.investopedia.com/terms/a/aml.asp>

RECOMMENDED SOLUTIONS

- **Need for state regulation**

It is being suggested that NFTs should be regulated by the government agencies. Government should work to make new laws or amendments in existing laws related to NFT copyrights.

Taking an example of *Indian Copyright Act, 1957*, there is a need to expand the purview of scope of works that can be copyrighted under Indian jurisprudence. Here the categories which can be copyrighted under **Section 139** should be updated and more things which can be a part of NFT should be added.

- **Multi-platform royalty**

Changes are needed to be done where the real owner gets the royalty by the sale of his/her NFT in no-matter-how in which market such is being sold. As the price of each NFT depends on the rarity of the original product, there are likely chances of the thing being sold in other markets owing to number of its fake copies.

- **Reduction in tax rates**

As the concept is new and fresh, government while imposing high tax rates, should consider the fact to attract more investors to this market which can only be done by lowering the tax rates.

- **Enhancing Safety and Security**

The transactions in NFT transfer mostly deal with huge sums of money. Therefore, it is important to look after the measures that can be adopted to upgrade safety and security.

By using strong passwords (choosing a combination of both capital and small letters, numbers and symbols) and always picking a password more than 8 characters. Also double checking the wallet password with NFT one.

- **Need for NFT Law**

There is an urgent for an international NFT Law, which could define the terms, processes and regulations that occur while trading NFTs in the marketplace.

A proper law is required which could define the whole procedure, set rules and impose penalties in cases of fraud and terror funding matters.

- **Solution to lack of contractual rights**

Whenever transactions related to NFTs are done, specification should be made more clearly. Information related to sub-token or metadata should be specified more clearly. Moreover, a detailed explanation should be provided about what rights and privileges come under the ownership made after NFT purchase.

- **Unification a solution to Fragmented Marketplace**

A decentralized exchange movement should be created where buyers can easily find, buy and sell NFTs with cohesive interface across an aggregated market pool. In other words, unification of NFT trade platforms should be done.

CONCLUSION

As the concept of NFT is new and fresh, questions related to its use and problems that come with its use will continue. However, the rate at which its market is expanding and the eager in people to learn this concept will certainly provide many solutions to existing legal implications that come up with. NFTs provide opportunities for those who issue, acquire and invest in NFT across a range of different sectors. Their potential to generate and sustain revenue streams is particularly overwhelming. Mostly in the context of art, sports, collectible sculptures and in areas where brand strength drives the true value.

Such opportunities, however, makes the suggestion for businesses to act carefully to avoid unintended regulatory and legal implications and to protect their desired interests. As it is widely said that “one must step forward with the eyes open”.

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