



NFTs – Intellectual Property, accounting and tax considerations

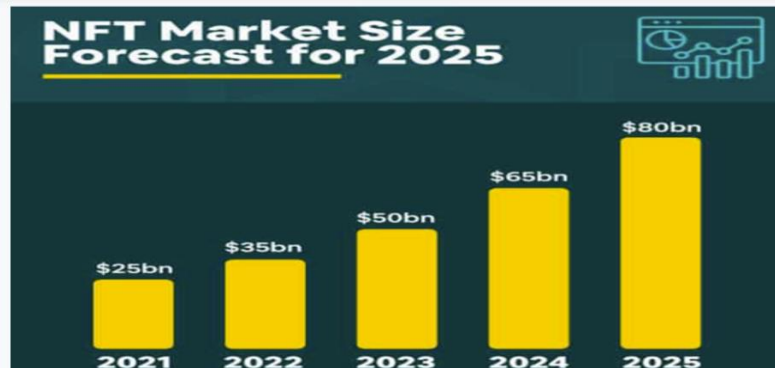
By Nupur Jalan

NFTs – An introduction

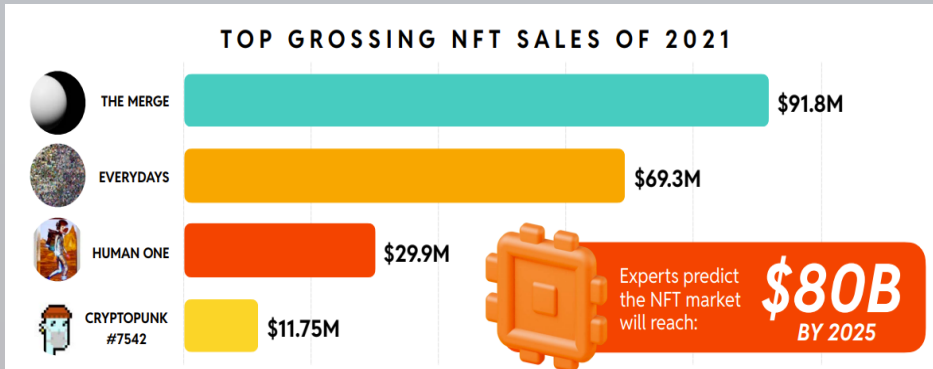
- Non-Fungible Tokens (NFTs) are acting these days as a boost to support the creator economy, and the market of NFTs are skyrocketing. People are exploring different way of commercialization through NFTs.

For example: [Christie's sold a mosaic of Beeple's pieces for more than US\\$69 million in 2021 – third most expensive work ever sold by a living artist](#)

- [NFTs are digital files having a unique identity that is verified on a blockchain \(i.e., it is a unique cryptographic asset that exists on a blockchain\)](#)
- In terms of intermediary, OpenSea is outperforming other NFT marketplaces to date where range of NFTs can be minted, purchased, and sold
- According market-cap forecast by the [Jefferies](#), the NFT market is forecasted to grow to \$35 billion in 2022 and well over \$80 billion in 2025



Source: <http://www.tokenizedhq.com>



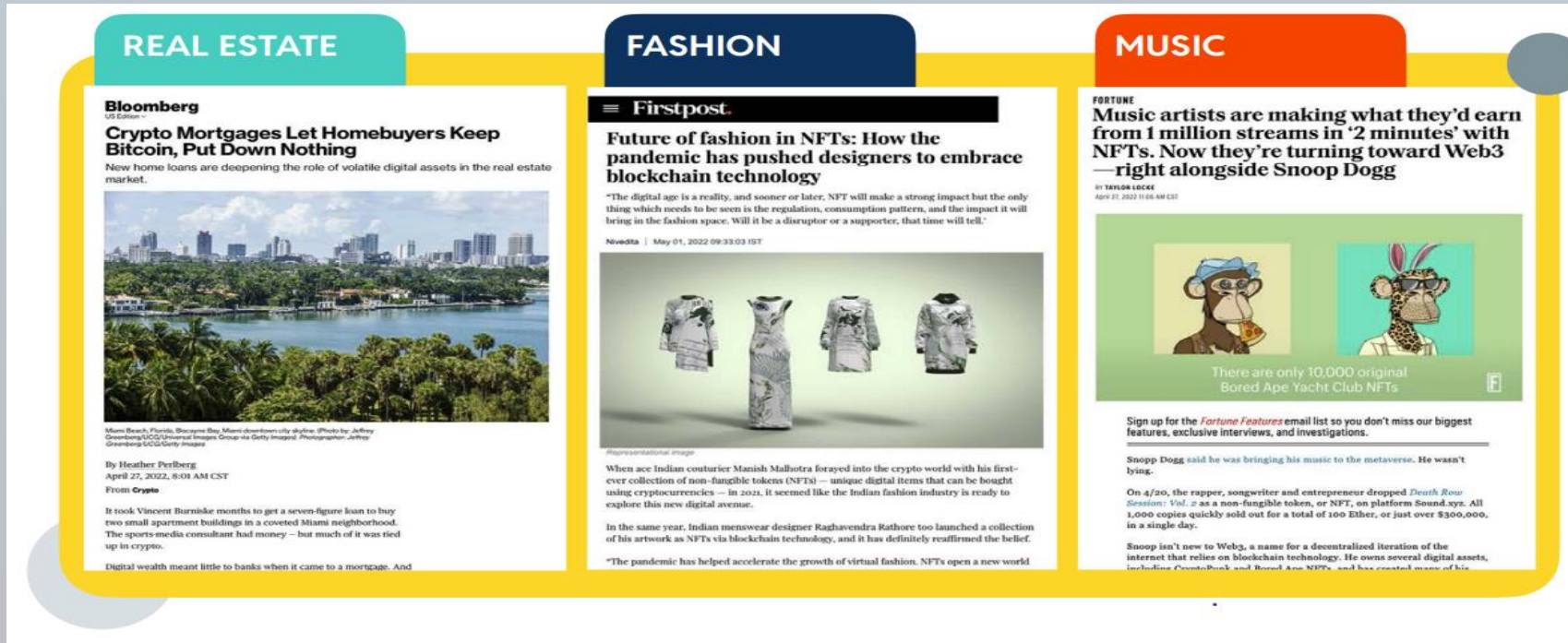
The ABCs of NFTS – The ultimate guide to NFTs, Reddit



Image Credit: La Cassette Bleue/Getty

NFTs – An introduction

- People are finding used cases in different industry from entertainment, fashion, art, and beyond



The ABCs of NFTs – The ultimate guide to NFTs, Reddit

For more: Refer <https://nupurjalan.com/nfts-its-growing-popularity-and-commercialization/>



Image Credit: La Cassette Bleue/Getty

NFT's and potential Intellectual Property issues

- There could be multiple Intellectual Property issues associated with NFTs patent, trademark, copyright etc. Intellectual property and NFTs has drawn lot of criticism across the globe. I will be covering mainly trademark and copyright
- [Intellectual property](#) (IP) laws protect, [among others, authors, inventors, producers,](#) designers and performers by granting them exclusive rights over their copyright, trademarks, patents, industrial designs or trade secrets

a. COPYRIGHT

- [Copyright law provides certain rights \(for example right to reproduce, distribute copies, publicly perform, and publicly display\) which are exclusive to the owner of the copyright in a work.](#) The following points arise in the context of NFT ownership, [the answer to which raises multiple copyright issues:](#)
 - *Rights conferred by the NFTs are not fixed and **depend upon the underlying contract***
 - *The **sale of an NFT is merely the sale of an entry on a blockchain additive ledger and not necessarily the work itself.***
 - ***Anyone can create NFTs (not necessarily the creator of the original work)***



NFT's and potential Intellectual Property issues

Is the copyright transferred to the buyer of the NFT by the seller of the NFTs?

- *Seller transfer the copyright to the buyer of the NFT*
- *Seller doesn't transfer the copyright to the buyer of the NFT*

Does the seller own the copyright of the work uploaded in the form of NFTs in the digital world?



NFT's and potential Intellectual Property issues

Situation 1: Seller does transfer the copyright to the buyer of the NFT

- [Covers situations where terms in the NFT's encoding expressly states the transfer of copyright ownership to the NFT owner along with the sale](#)

Exception: there can be situations where the original owner gives the right to create a limited number of NFTs; a creator may grant rights to create a limited number of NFTs associated with a copyrighted work. [For example: 'CryptoKicks' where Nike could tokenise ownership of shoes by linking an NFT to a physical shoe. This would allow designers/businesses to have control over their shoe design – like limiting the number of copies that can be produced.](#) In some situations, the buyer have to pay royalty for every further sales to the original owner

Separately, there may be a situation that the transfer of copyright online doesn't comply with all legal formalities. For example, [the requirement of the Copyright Designs and Patents Act 1988 \(CDPA\) of the UK states that copyright assignment has to be 'in writing signed by or on behalf of the assignor'.](#) [In such cases, the sale of an NFT can be accompanied by a contract for sale, deed of copyright assignment or deed of copyright license, which expressly sets terms for copyright](#)



NFT's and potential Intellectual Property issues

Situation 2: Seller doesn't transfer the copyright to the buyer of the NFT

- The NFT holder just has the token, but this in itself doesnot confer ownership of the underlying artwork
- The purchase of an NFT can, can get at max quasi-ownership interest in certain information or metadata linked to [copyright-protected content](#) - only limited personal non-commercial use is transferred
- What is mainly granted is non-exclusive, non-transferable, royalty-free license to use, copy and display the purchased item for personal, non-commercial use



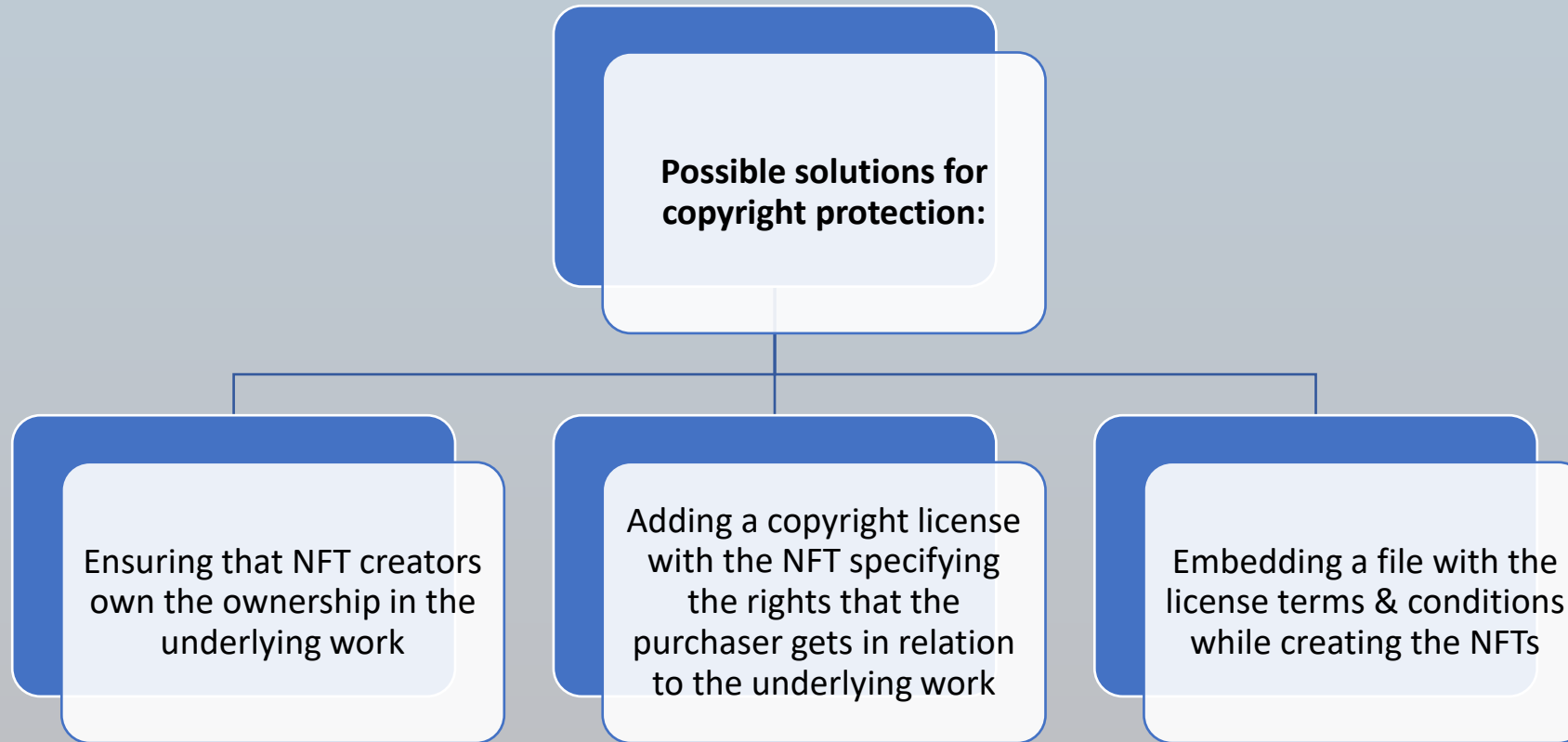
NFT's and potential Intellectual Property issues

Does the seller own the copyright of the work uploaded in the form of NFTs in the digital world?

- [Many artists have complained that their works are used for creating NFTs without their permission.](#)
- Some NFT trading platforms have made stringent regulations for listing the NFTs on their website to avoid such practices.
- Such conduct of copying the work of others or misrepresentation of ownership over the result is a challenge in relation to NFTs due to the anonymity features of the blockchain, which make it difficult to identify the true owner of [copyright in the underlying work of an NFT.](#)



NFT's and potential Intellectual Property issues



For more: Refer <https://nupurjalan.com/nft-and-copyright-issues/>



NFT's and potential Intellectual Property issues

b. TRADEMARK

- Trademark law provides an exclusive right to the right holder and grants protection to a sign, logo, etc., concerning the goods and services for which trademarks are registered
- Can the exclusive right and protection granted to the trademark holder for physical goods could cover the [protection for the same goods in the virtual world too?](#)
- There can be [arguments on both sides](#) -
 - Argument 1: Virtual products/ NFTs in the metaverse are a **mere representation of physical goods** – these merely relate to the image/ pictorial representation of the physical goods
 - Argument 2: Trademark right is **only limited to registered goods or services or goods of similar nature** – as **physical products cannot be the same as virtual products**, trademark for physical goods cannot cover virtual products if the trademark is not provided also in the class covering computer software or related class which can cover virtual products



NFT's and potential Intellectual Property issues

- Separately, there is a possibility that the above arguments [may not apply to a trademark that has the legal status of the trademark with reputation](#) – in such cases; the trademark holder can prevent the use of the trademarked item in the virtual world too, where the use by a third-party tantamount to taking undue advantage of the distinctive character or reputation
- Many reputed companies are filing applications to cover metaverse transactions to be more secure even if they hold a trademark with a reputation (NYSE, DKNY, PUMA, Gucci, Prada, Nike etc.)
- These companies are filing applications mainly [in the following categories](#):
 - *Class 9: Downloadable virtual goods, computer programs*
 - *Class 35: Retail store services featuring virtual goods; entertainment services*
 - *Class 36: Financial services, including digital tokens*
 - *Class 42: **Online non-downloadable virtual goods and NFTs***



NFT's and potential Intellectual Property issues

1. Nike sued StockX (a marketplace in the metaverse) for commercializing Nike's footwear as NFTs. NFTs represented existing Nike shoes but were tied to the physical sample. Consequently, when customers purchased the NFT, they also acquired the right to exchange it with a physical version of the footwear. However, StockX granted exclusive benefits to consumers where they keep these NFTs instead of exchanging them for real shoes

Nike's line of argument was that this could be misleading for consumers, as they may believe they were purchasing authentic Nike NFT products. Accordingly, Nike considered this harmful against its established reputation as consumers can consider StockX as the authorized NFT retailer

2. Luxury brand Hermès (a French company) sued American artist Mason Rothschild for creating and commercializing in the metaverse around 100 NFTs with the name MetaBirkins extremely similar to the 'Birkin' (a popular bag category 'Hermès Birkin')



NFT's and potential Intellectual Property issues

Arguments of both parties:

<i>Hermès</i>	<i>Rason Rothschild's</i>
<p>The artist registered and used the domain name 'MetaBirkins.com', obtaining an economic revenue and taking unfair advantage of their established trademark – <i>'MetaBirkins brand simply rips off Hermès' famous Birkin trademark by adding the generic prefix 'meta' to the famous trademark Birkin'</i></p>	<p>NFTs created are artistic representations of imaginary 'Birkins'- his entire argument encircles around the point that he should be allowed to 'create art based on [his] interpretations of the world around [him]'. According to Rothschild, Metabirkins depict 'furry Birkin bags, reflecting his comment on the fashion industry's animal cruelty and the movement to find leather alternatives'</p>
<p>The artist had used a disclaimer on the MetaBirkins site, which reads: 'We are not affiliated, associated, authorized, endorsed by, or in any way officially connected with the HERMES, or any of its subsidiaries or its affiliates'. Hermes mentioned that this 'disclaimer actually made matters worse by excessively using the brand's name and unnecessarily linking to its website'</p>	<p>His arguments were also based on the 'Fair use' defence. He even referenced Andy Warhol's Campbell Soup Cans series as justification for why he should be allowed to promote/sell MetaBirkins NFT collection</p>



NFT's and potential Intellectual Property issues

In the lawsuit, Hermès demanded damages along with the request to place an injunction on Rothschild NFTs by destroying previously minted NFTs and that the domain for the project's website should be turned over to Hermès. OpenSea had delisted MetaBirkins for sale in the primary market.

Snapshot of the open letters on the artist's Instagram account:

Dear Hermès,

So, I got your cease & desist letter. While I am sorry if you were insulted by my art, as an artist, I will not apologize for creating it.

Now, as you are aware, the First Amendment gives me every right to create art based on my interpretations of the world around me. There are countless examples of artists who reference the world and the products and cultural artifacts in it. With that understanding, MetaBirkins is a playful abstraction of an existing fashion-culture landmark. I re-interpreted the form, materiality and name of a known cultural touchpoint. MetaBirkins are also a commentary on fashion's history of animal cruelty, and its current embrace of fur-free initiatives and alternative textiles. My aim is always to create additive art projects that contribute positively to the culture.

When it comes to art, selling my MetaBirkins as NFTs is akin to selling them as physical art prints. It should not be my job to educate you on advancements in the world and the culture of art. Art is art.

There is a moving tide of innovation and evolution, and it is your role as a fashion powerhouse to amplify young creatives and artists rather than stomp them out. Your actions can help determine the future of art in the Metaverse.

You can be a part of an incredible movement.

Dear Community,

So, Hermes filed a trademark lawsuit against me on Friday—although they didn't send me or my lawyers a copy. My lawyers and I have reviewed Hermes' complaint. Hermes' claims are groundless and we look forward to defeating those claims in court and helping to set a precedent.

I am not creating or selling fake Birkin bags. I've made art works that depict imaginary, fur-covered Birkin bags.

My lawyers at Lex Lumina PLLC put it well when they said that the First Amendment gives me the right to make and sell art that depicts Birkin bags, just as it gave Andy Warhol the right to make and sell art depicting Campbell's soup cans.

I have the right also to use the term "MetaBirkins" to describe truthfully what that art depicts, and to comment artistically on those bags and on the Birkin brand.

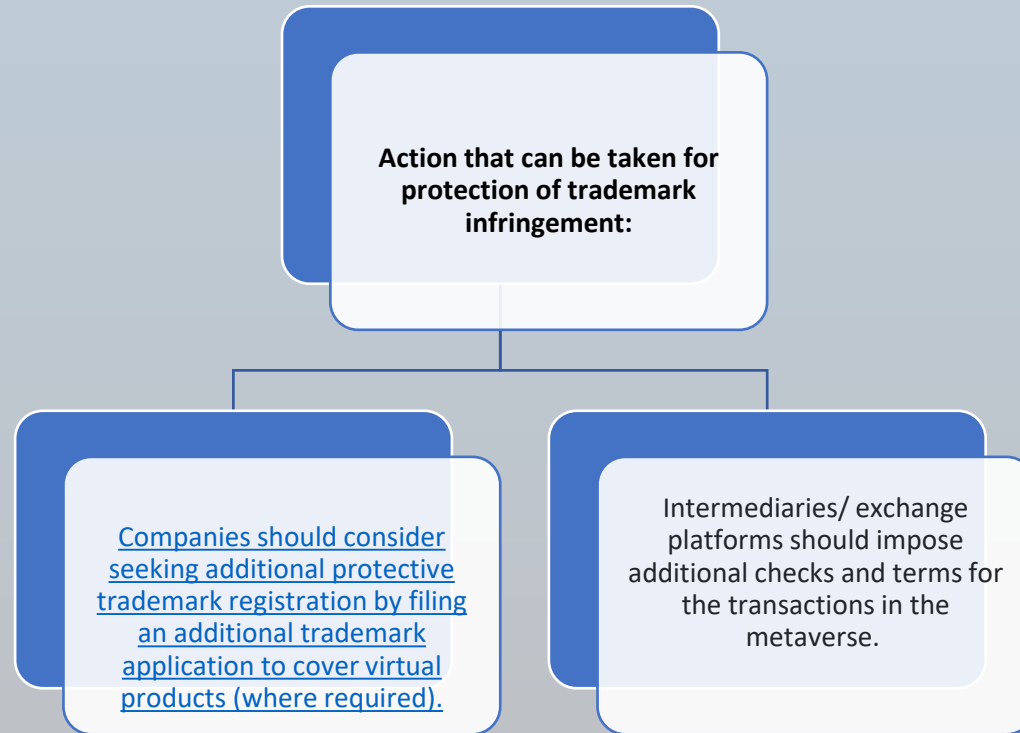
The fact that I sell the art using NFTs doesn't change the fact that it's art. It's quite clear from reading Hermes' complaint that they don't understand what an NFT is, or what NFTs do.

We have tried to be reasonable. Hermes first sent me a letter threatening a lawsuit if I didn't knuckle under and stop doing MetaBirkins altogether. We wrote to them and explained that we were doing nothing we didn't have a right to do. We told them that we believed that the dispute could be resolved through an informal conversation between me and an Hermes representative. Hermes chose instead to break off negotiations and sue me.

I hope Hermes understands that I won't be intimidated.



NFT's and potential Intellectual Property issues



For more: Refer <https://nupurjalan.com/metaverse-and-trademark-rights/>

Litigation cases in relation to NFTs and IP has increasing – U.S. Patent and Trademark, and Copyright offices are launching a study into the impact of NFTs on IP rights



NFT's and accounting considerations

PURCHASER OF NFTs:

Right to an underlying digital asset or the right to an underlying physical good in received –
Based on the nature rights transferred, the assets would be recorded in the balance sheet of the purchaser.

Separately, depending on the applicable Accounting standards, the entity may need to revisit fair value and may have to do impairment of the assets if fair value is lower than the amount at which asset was recorded.

SELLER OF NFTs

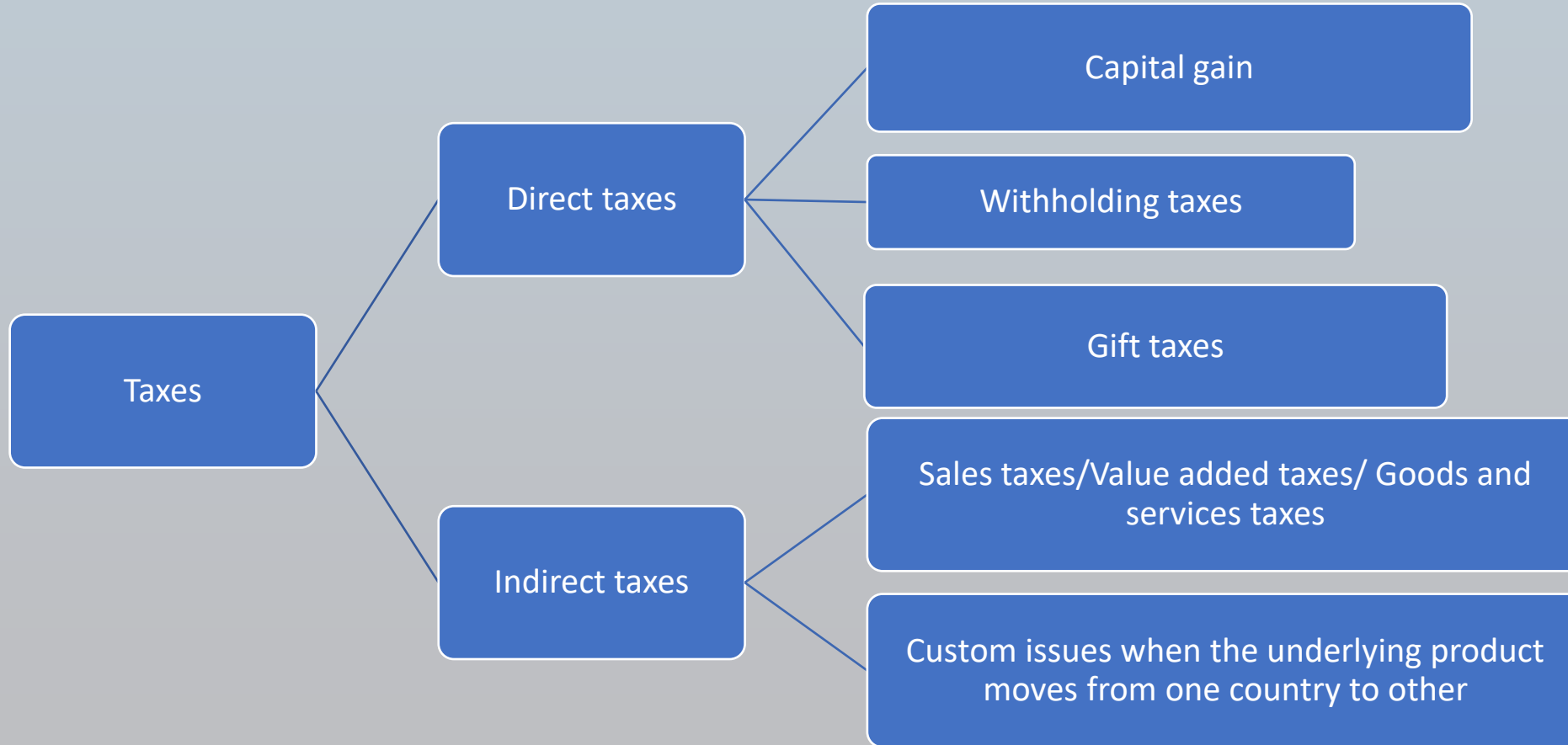
IP license: The entity may license its IP allow other parts to mint and sell it in lieu of license fees. In such cases, license fees will be recorded as income of the entity.

Creation of own NFTs: If the entity decide to mint the NFTs themselves, then entity would have to do proper recording of the expenses related to minting (appropriate consideration should be made to the characterization of the income – i.e., they treated income from sale of NFT as business income or capital gain income).

Exchange platforms: If the entity is running marketplace for trade of NFT's, depending on the characterization of the platforms as agent/principal; accounting will be performed. For ex. If exchange platform acts as agent, it may only treat commission income as their revenue.

NFT's and potential tax considerations

- From tax side, there could be implications from both direct and indirect tax side depending on the laws of the country. Some of the applicable taxes could be:



NFT's and potential tax considerations

➤ NFT seller is the original owner

Situation 1: When NFT seller and purchaser of NFT is in the same country:

Depending on the rules in the domestic tax law of the country, NFT transactions may be taxed under both direct taxes and/or indirect taxes.

NFT seller: the sale of an NFT shall give rise to a taxable gain/loss. The characterization of the gain/loss depends on the nature of asset in which NFTs are treated for the taxpayer.

VAT may also apply depending on the country laws.

Illustration 1: Mr. A (purchaser) & Company XYZ (seller) are residents of Country C. Company XYZ holds NFTs as an asset held for investment. In this case, depending on the laws of Country C, Company XYZ will have capital gain/loss on sale of the NFTs. Accordingly, capital gain tax may apply. Separately, depending on the VAT laws, if Country C levies VAT on this transaction, Company XYZ will have to charge VAT additionally to Mr. A and pay to the tax authorities.

Suppose, in the above case, Mr. A pays the consideration through cryptocurrency. In this case, if Mr. A acquired cryptocurrency at say \$2000 and now the same cryptocurrency is used to buy say NFTs worth \$6000; this could mean that the value of cryptocurrency held by Mr. A has increased and he have to separately account for capital gain/loss on the cryptocurrency too and pay taxes accordingly depending on the laws of Country C.



NFT's and potential tax considerations

➤ NFT seller is the original owner

Situation 2: When NFT seller and purchaser of NFT is in different country:

Cross-border tax issue could arise, and taxability may need to be determined under the domestic law and the applicable tax treaty. VAT may also apply depending on the country laws.

If in the same Illustration 1 discussed in the previous slide, if Company XYZ is located in Country D instead on Country C, then reference would need to be placed to the relevant tax treaties additionally to determine the ultimate taxation of the gain/losses for Company XYZ in addition to the domestic laws of the countries (in situation where such income is taxable in the domestic law of the countries).

Characterization of income/loss needs to be determined for seller i.e., whether it is business income, capital gains etc.



NFT's and potential tax considerations

- **NFT seller/ distributor is not the original owner and royalties needs to be paid to original owner**

Apart from the points mentioned above, there would be additional taxes that could be applicable on the royalties received by the original owner. The original owner may be located in the same country as that of seller or different country.

Depending on the laws of the country and additionally applicable tax treaty (in cross-border situation); the payer of royalty may need to withhold taxes on royalties paid. The royalties received will also be taxable in the country of the recipients(i.e., original owner too). In case of double taxation, the resident state of the recipient (i.e., original owner) should provide foreign tax credit.



NFT's and potential tax considerations

➤ Other relevant point for determination of direct/ indirect taxes :

Items being sold or transferred?

- Tangible or intangible property? – *It could be regarded as tangible property where NFT gives right to the purchaser to get the underlying physical products too*
- Single product/ service or bundled goods/ services
- Sale of IP or a limited license of right to use IP? *For example. Like discussed earlier, it needs to be checked whether it is outright sale of copyright which give the purchaser the complete right over exploitation of IP or purchaser has limited right of exploitation of IP*

Place of supply?

- Can the country of customer be identified – *Country of customer can be identified on various metrics that are applied for digital goods/ services like billing address on invoice, customer IP address, contract terms and conditions*

How purchase consideration for NFTs are paid?

- *There can be situation in which purchase consideration could be paid in crypto currency. In such cases, there could be gain/ loss for the buyer too on the crypto-currency used for payments*

Local laws of the country

- Is there law in place in country under which NFTs can be taxed?
- Determination of tax characterization of item/s being sold (as mentioned earlier)



NFT's and potential tax considerations

Potential transfer pricing issues

Let's presume Company A (parent company), Company B (subsidiary 1), Company C (subsidiary 2) are related party.

The parent Company A grants pre-existing license of IP to Company B for minting the NFTs under the licensing agreement. Company C runs an exchange platform for NFTs and also sells NFTs minted by Company B.

Transfer pricing considerations:

- License fees – appropriate benchmarking of licensing fees needs to be done (challenge may be found comparable in this case)
- Commission: Considering Company C runs platform on agent model, where it takes commission for others for trading on its platforms – in this case, Company C should charge commission from Company B too for selling the minted NFTs on its platform and the same should be at arm's length price



NFT's and potential tax considerations

Details into recent Spanish tax ruling on VAT on NFTs*

- The Spanish tax authorities recently issued a ruling which analysed VAT treatment on NFTs. Ruling provides detailed analysis on VAT treatment for NFTs (around taxable status of supplier, quantification of transaction electronically supplied services, the place of supply and formal reporting obligation under the new OSS scheme)
- The ownership of the underlying artwork not transferred – NFTs only granted its purchaser certain rights of use
- The authorities considered seller as the taxable person for VAT
- Transfer of NFTs in this case was regarded as 'supply of services'. Per the ruling, VAT was accorded similar treatment as that of 'electronically supplied goods'
- Taxability:
 - B2B case: Standard rules for B2B transactions apply
 - B2C case: The supply will be taxable in the state of consumption and seller will charge VAT @ applicable rates. This ruling also mentioned, the billing address, the address of the IP used or any other commercially relevant information as metrics for determining the customer residence
- Spanish VAT was held to be applicable on the NFT transactions in the facts of the case

*Binding ruling V0482-22, of March 10, 2022, issued by the Spanish General Directorate of Taxes (*Dirección General de Tributos*).



NFT's and potential tax considerations

India case :

- The Finance Bill 2022 brought in new taxation mechanism for taxation of Virtual Digital Assets (VDA). The provisions is wide enough to cover NFTs. The taxability triggers on gains or income arising on transfer of VDAs including NFTs. It is taxable at flat rate of 30% plus applicable surcharge rates as the case may be and Health and Education cess @4%
- No deduction allowed for any expenditure other than cost of acquisition. Also set off of losses, arising on sale of VDAs is not permissible against any other income and there is no carry forward of these losses
- Where VDA is given as a gift, it will be taxable as income from Other Sources for the receiver
- Further, from 01/07/2022 onwards any person who is responsible for paying any consideration to an Indian resident for transfer of a VDA is required to be deduct TDS at the rate 1% where the threshold limit is crossed



Conclusion

- In spite of the legal, tax and regulatory issues that exist/ may come up in the coming times, if one were to think from a positive outlook, NFTs do bring together different content creators from interdisciplinary fields under one ecosystem, thereby opening new avenues for inclusive growth for all ecosystem contributors
- There is uncertainty in relations to clear legal & regulatory compliance mechanism in certain cases. This is mainly because of the lack of wide precedents & guidance and only time will tell how different litigation is settled in this regard
- Appropriate actions can be taken to safeguard IP rights, for example: *A physical contract can be linked to the smart contract, which governs an NFT, and the physical contract could specify various terms and conditions of the legal world, including copyright*
- In coming times, more and more countries will try to levy taxes and regulate NFT transactions, hence proper analysis of applicable tax laws and other potential regulatory implications is advisable to be undertaken