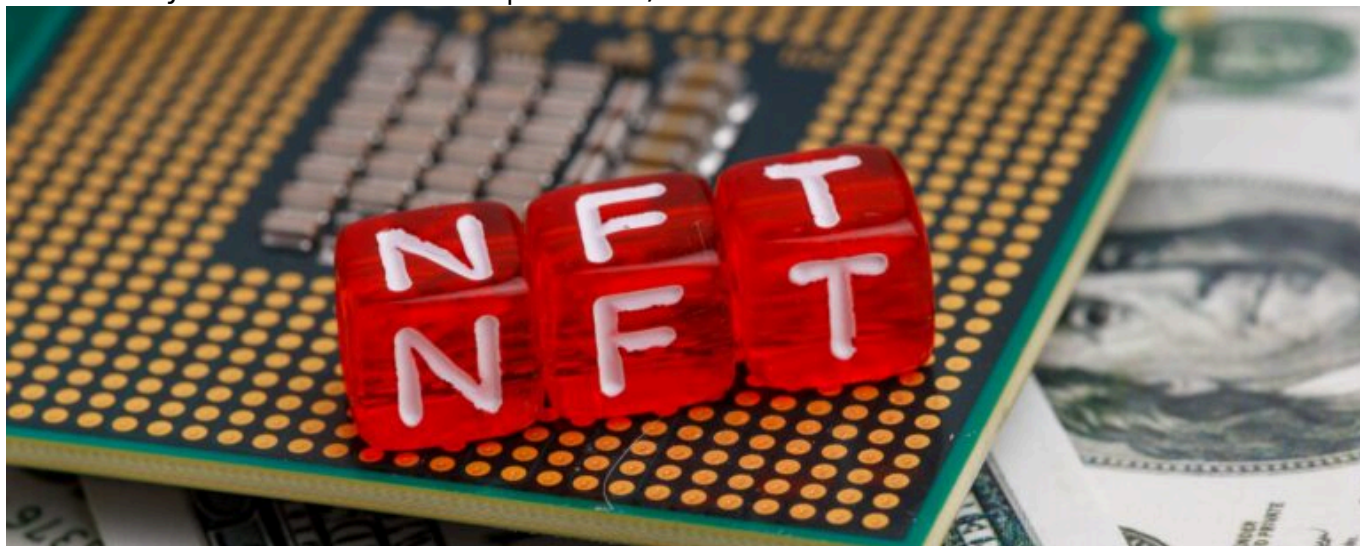


Non-Fungible Tokens in India: 6 Legal Implications Buyers Must Consider

written by Prashant Kataria | June 1, 2022



Legal Implications of NFTs

Non-Fungible Tokens (NFTs) are digital assets that can be used to establish the ownership and value of an underlying digital asset, such as an original image, video, or audio. They are issued on these assets using blockchain technology and smart contracts, which generate unique digital signatures and establish their security. They are currently a highly speculative market to invest in, prone to rapid plunges or upswings and cyber security threats, making them enormously volatile assets to acquire and maintain.

Something that NFTs are attempting to be a solution to is the need to confirm ownership. Currently, digital content over-saturates the internet and tracking and identifying the original owner of work placed on virtual platforms is sometimes challenging, resulting in a decrease in the value of the original work since they are easily replicated and redistributed.

NFTs are thus an attempt to enforce decentralization, ownership tracking, and value storage, while also making the lawful owner's claim to the original work visible in the event of duplication. It aims to act as valid proof of ownership and grants the creator "digital bragging rights" through traceable proof of ownership.

However, the legality of such digital assets remains a major concern.

Concerns have been expressed regarding the legal status and the authenticity of such tokens, especially in India.

Followers of NFTs in India and the Legal Implications of NFTs have also raised doubts about the tokens' long-term sustainability because of the absence of any explicit regulations or legislation prohibiting or banning Indian residents from purchasing or selling NFTs. The most significant hurdle to NFT trading appears to be the uncertainty surrounding cryptocurrency's legal status in India since the underlying technology in both cases is a common denominator.

Legal Implications of NFTs

NFTs and cryptocurrencies both use the same blockchain technology, and the NFTs are usually acquired using cryptocurrency. Keeping this in mind, analysis of the legality of cryptocurrencies becomes important to understand the legal implications of NFTs.

1. General Law

Although cryptocurrency has been present and around in India for the last ten

years, the primary debate about its legality began in June 2018, when the Reserve Bank of India (RBI) issued a circular advising banks not to deal in cryptocurrencies.[1]

The Supreme Court struck down the RBI's order in *Internet and Mobile Association of India vs. Reserve Bank of India* stating the right to trade is a basic right under Article 19(1)(f) of the Constitution, and thus, cryptocurrencies could be lawfully traded.

2. Security Law

Whether trading in NFTs is prohibited under the Securities Contract Regulation Act, 1956 (SCRA) is uncertain because there is no formal or legal structure of legislation for NFTs. As a result, there is no categorization of NFTs under the SCRA. Some consider NFTs to be contracts, while others consider them to be derivatives. Trading in NFTs would be illegal in India if the latter is true.

To explain this further: under Section 2(ac) of the SCRA, the term "derivative" is defined as "a contract whose value is derived from the prices of the underlying securities". If NFTs are considered derivatives, they cannot be traded on virtual platforms as per Section 18a.

The non-fungibility of NFTs distinguishes them from other forms of securities. As a result, if an NFT is simply a reference to an existing asset and is provided as proof of its authenticity, classifying it as security (derivative) would be incorrect. Rather, it should be guided by generic contract standards. Furthermore, if a return on investment is offered, NFTs would appear to be a "hypothetical investment" and not a digital collection, and hence may be classified as a security in India and be subject to regulatory frameworks.

3. Copyrights Act

Although, as mentioned above, NFTs are an attempt to establish "ownership" of a virtual asset, owning an NFT does not necessarily entail ownership of the work of art represented by the NFT. When the NFT is purchased, the owner does not get the copyright to the underlying piece of art. According to Section 19 of the Copyright Act of 1957, to transfer copyright and be regarded as an owner, a written sale contract declaring explicit assignment of copyright must be present.

Under Section 14 of the Copyright Act, only the owner of a work has the right "to reproduce and distribute copies of it". As a result, unless the buyer and seller expressly restrict resale or copying of the NFT, such action is illegal. Unless the parties agree, the copyright often remains with the originator of the work.

As a result, the buyer cannot establish ownership over the object unless the possessor specifically transfers their rights. Instead, the buyer's digital item is simply protected from others illegally copying or disseminating the image under the Copyright Act, though this has done nothing to prevent many from right-clicking an NFT image and saving it as a jpeg file or simply taking a screenshot (though features have been built into NFT images of late whereby taking a screenshot of the NFT image would lead to a blurry image, which would be useless).

4. Income Tax Regulations

In most cases, the type of the underlying asset should dictate the tax treatment of NFTs. Example: For income tax and Goods and Services Tax (GST) purposes, a digital art NFT could be considered an intangible asset or good,

and taxes should be declared and remitted on the same.

With that in mind, the government recently declared a flat 30% tax on any income from all virtual digital assets, which includes NFTs. Such heavy taxation is bound to be discouraging to newcomers and day traders who make multiple transactions in a single day. If this causes current and potential investors to exit the sector, the value of such crypto and associated digital assets could plummet sharply -- although it is nigh impossible to predict any trends when it comes to crypto since it is so volatile in nature.

Further, NFT transactions are cross-border and digital, new tax problems are popping up every day. For example, sales of NFTs by offshore sellers to Indian buyers through an offshore NFT marketplace may be subject to a 2% equalization fee[3] based on the NFT's gross value and the marketplace's income from Indian customers. However, whether or not the platform's revenue or commission is also lost in this circumstance is debatable.

5. Foreign Exchange Management Act Regulations

The classification of the underlying asset being transferred via the NFT, whether physical or digital, would decide the treatment under current Foreign Exchange Management Act (FEMA), which regulates cross-border transactions. To stipulate, NFTs may be categorized as "intangible assets" and governed under the software and intellectual property laws part of the FEMA regulations. Hence, determining their location is important since they are supported by "global ledgers", which means that the information is logged, shared, and synchronized across data stores.

6. Collective Investment Schemes

Collective Investment Schemes (CIS) can be in the form of 'investment funds' or 'mutual funds. The qualities of an NFT, as well as the rights granted to the token purchasers, will determine whether it is a financial instrument or not and the non-fungibility of the token has no bearing on the NFT's regulatory status.

If the main objective of the NFT is to grant the ability to retain, purchase, and sell the asset, it is likely to be classified as a utility or exchange token. The issuance of NFTs that qualify as CIS units may require registration and acquisition of a collective investment undertaking license.

As per the Securities Exchange Board of India (SEBI), an existing CIS that fails to file a registration application or is denied provisional registration or does not comply with the SEBI guidelines on Collective Investment Schemes after being granted provisional registration must be wound up and may also be subject to other penal provisions under the SEBI Act.

What's Next? Conclusion - Legal Implications of NFTs

To conclude about Legal Implications of NFTs, there is no separate legal framework for NFTs in India and they are currently only governed by the general principles of contract. Most buyers and enthusiasts are keen to jump on the NFT bandwagon to make a quick buck. That said, there has been a downturn in interest when it comes to buying them. Several economic experts, including Noble laureates, have said that crypto contains no intrinsic value and have likened NFTs to scams such as pyramid (multi-level-marketing) schemes, Ponzi schemes or the "greater fool" scam.

Users have also reported their wallets being hacked and NFTs or crypto tokens being stolen by individuals since many of these platforms lack stringent cybersecurity measures - for instance, in February 2022, OpenSea (one of the

largest NFT trading platforms) admitted it had been targeted by a phishing attack that caused its 32 users to lose NFTs worth a collective \$1.7 million. As such, the sale and purchase of tokenized artwork raises concerns about the ambiguity surrounding its legal validity, and other legal issues such as the enforcement of copyright holders' and NFT holders' rights, creator and holder liability, the applicability of various other intersecting laws, the exhaustion of copyright holders' rights after the first sale and multiple other concerns. When it comes to NFTs, it would be prudent to follow the Latin maxim *caveat emptor* or 'buyer beware'. Those that transact digitally in NFTs need to be aware of the dangers and risks associated with them before treading in such murky waters.

1. RBI/2017-18/154, DBR.No.BP.BC.104/08.13.102/2017-18, April 6, 2018
<https://rbidocs.rbi.org.in/rdocs/Notification/PDFs/NOTI15465B741A10B0E45E896C62A9C83AB938F.PDF>.
2. Internet and Mobile Association of India vs. Reserve Bank of India, 2019 SCC OnLine SC 1800.
3. Section 165A, The Finance Act 2020.
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