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LEGAL ENFORCEABILITY OF NFTS AND VIRTUAL PROPERTY

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ABSTRACT

Non-fungible tokens (NFTs) have transformed the world's perception of ownership by assigning digital collectibles and artwork to online assets that can be transferred and traded, however the legal infrastructure regulating these assets has failed to keep pace with the technological advancements. This paper examines the legal enforceability of NFTs and virtual property in India. It evaluates the applicability of the existing legal frameworks, including the Copyrights Act, Income Tax Act, and the Indian Contract Act to bridge the regulatory gap in India. The paper first analyses the technical foundation of NFTs and draws a clear distinction between the token and the underlying asset. Further, the paper assesses the enforceability of smart contracts and the concerns regarding informed consent and the gap in the framework to regulate self-executing code. The paper concludes with suggestions to bridge the legal blind spots in the Indian landscape in regulating these non-fungible tokens.

INTRODUCTION

Jack Dorsey, the CEO of Twitter (now X), sold his first ever tweet, "just setting up my twttr" for $2.9 million to Malayasia-based businessman. The tweet was auctioned off for charity as a non-fungible token (hereinafter NFT). Similarly, digital highlights of basketball players are sold as NFTs on 'NBA Top Shot', as a way of sports collectibles and memorabilia. Through the sale of things as intangible as tweets and online player highlights, NFTs changed the world's perspective on ownership – illustrating that items beyond the physical world holds value.

NFTs are unique digital certificates that represent some underlying work, that can be owned, transferred and traded and are displayed on public online ledger called the blockchain. During covid, the concept of NFTs and blockchain technology rapidly grew from a niche technological advancement to a modern digital marketplace. The growth of these tokens has far succeeded the law, creating a gap in regulating ownership rights and copyright issues. However, buying an NFT does not grant the buyer ownership over the linked asset, rather just ownership of the token itself, thereby giving rise to a lot of legal uncertainty.

India has no particular law addressing NFTs and no clear jurisdiction to settle disputes that would arise regarding the same. Since, there is no statute governing these tokens, the already laws have to make do for its governance. The legal frameworks that are in place that can be referred to oversee NFTs include a new provision in the Income Tax Act, defining 'virtual digital assets', Copyright Act, Contract Act and Intellectual Property rights. This article examines the legal enforceability of NFTs and virtual property in India by assessing it in comparison to the existing legislations and identifying the regulatory blind spots.

CHARACTERISTICS OF NFT

Non-fungible tokens are based on 2 key concepts – non-fungible and tokens. Firstly, the idea of fungibility or how replaceable an item. NFTs work on the idea of scarcity and rarity, and are therefore unique and one of a kind. No two NFTs will have the same value as the other and thereby not mutually interchangeable, unlike fungible tokens like cryptocurrencies or bitcoin.

NFTs are represented by a unique digital certificate that are tokenised through a blockchain. Blockchain is a public decentralised digital ledger that can be accessed from a system of computer servers. In the context of NFTs, it acts as a transaction database that records every exchange or transfer that takes place. Since, there is a record of each transaction that is publicly accessible, it makes it harder for people to fraudulently alter the information. Thus, making NFTs reliable and securely verifiable by buyers and sellers. To convert a digital asset into an NFT, the process of tokenisation needs to be undertaken. After tokenisation, a unique token is created that lives on the blockchain via which the underlying asset can be accessed. The asset itself is not available on the blockchain but stored elsewhere which can be retrieved only through the token. The token contains metadata which is most commonly a simple URL, which when clicked leads to the asset. Understanding this distinction between the token and the underlying asset is what forms the foundation for legal analysis.

COPYRIGHTS ACT, 1957

The legal issues that mainly arise regarding NFTs and virtual property in India relate to Intellectual Property, mainly concerning whether purchasing a token grants any copyright in the asset it represents. Under Copyright Act, 1957, copyright of an original literary, dramatic, musical and artistic work, films shall be vested in its creator upon its creation. Section 14 of the Copyright Act outlines the rights that comprise a copyright and the rights to communicate and reproduce the work. Additionally, Section 18 and 19 deal with assignment and mode of copyright. Section 18 talks about how the owner of the copyright can assign either all the rights or some rights to another individual and Section 19 requires that the assignment of copyright be made in writing and what rights would be conferred to the assignee along with the duration and territorial limits. The assignment of copyright can only take place when it is clearly written down in a document.

Applying these key Sections to NFTs, it can be interpreted that owning an NFT on its own does not confer copyright over the underlying work to the buyer of the NFT. However, the person who is the current owner of an NFT has the limited right of publicly displaying the NFT on his digital wallet for everyone to see, but does not grant him the rights of reproduction or adaption of the work. The copyright of the linked asset will remain with the creator of the work as per Section 18 of the Copyright Act and the original artist can mint more tokens for the same work.

The Indian NFT marketplace is smaller as compared to international platforms and is still growing and hence, follows a similar format in drafting its terms and conditions. Due to this, it does not fulfil the requirements of Section 19 of the copyrights Act. The terms are very generic and vague with very little to no reference to Indian legal statutes and it fails to specify the rights that come along with the token. The main problem that plagues the Indian NFT platform is that token ownership does not equate to copyright ownership, which creates a gap between buyer expectation and legal status.

INCOME TAX ACT

The only place in Indian Laws that mentions NFTs, is not in any legislation concerning Intellectual Property or property, but rather in the Income Tax Act, 1961. The finance act, 2022 incorporated the definition of ‘Virtual Digital Property’ under Section 2(47A) which broadly includes NFTs, cryptocurrencies and other kinds of digital assets. Section 115BBH states that any income gained from a virtual digital asset would be taxed at a flat rate of thirty percent excluding the applicable surcharge and cess and it is irrespective of how long the NFT has been held for. Unlike the way that the regular capital gains are taxed, wherein a differentiation between long-term and short-term holdings are made, the NFT sales are all taxed in the same standard way as prescribed under Section 115BBH of the Income Tax Act. Additionally, under Section 194S, a one percent TDS (tax deducted at source) is imposed on the buyer. This regime is highly rigid imposing more of the obligation on buyers rather than sellers, putting in place a framework that taxes the transaction itself, creating the question of what rights the buyer actually got.

SMART CONTRACT AND ITS ENFORCEABILITY

NFT transactions are normally accompanied with smart contracts automatically executes itself once the conditions are met. Smart contract is a code that self-executes that the conditions set out for the transaction of a particular NFT are fulfilled.

A valid contract under section 10 of the Indian Contract Act, 1872 includes an offer, acceptance, lawful consideration, object and the free consent of all parties involved. Implementing the framework of an NFT-transaction and smart contracts on the requirements of the Indian Contract Act, posting the NFT for sale on the appropriate platform constitutes an offer and the transfer of digital currency and wallet transaction constitutes acceptance and consideration. However, Indian courts have yet to explore this aspect of NFT disputes, further adding to the problem of the legal uncertainty regarding the regulation of digital assets.

Smart contracts are essentially a bundle of code that is programmed to execute on its own once the pre-existing conditions are met, thereby creating the question of free and informed consent. Since many buyers may not understand or may have never read the many lines of code that underlies the transaction of NFTs, the consent given is not fully informed or free. Furthermore, it is unclear how a court would go about granting remedies and compensation owing to the fact that the transactions made on the blockchain are irreversible.

Another limitation of a smart contract is its relationship with intellectual property. A smart contract just carries out the task that it was programmed to do, that is transfer the token from one wallet to the other. Therefore, on the blockchain, only the transfer of ownership is recorded, however, it cannot verify whether the minter of the NFT had any copyright over the linked work, neither can it confirm that the assignment of the token is done as per section 19 of the Copyright Act. Smart contracts are still a new and developing aspect which is undergoing legal scrutiny, hence, to resolve the issues at hand, a legally valid document is required to be drafted along with the smart contract, to make the NFT transfer legally strong and verifiable.

CONCLUSION

The NFT world is a niche marketplace giving the opportunity to buyers and sellers to engage with, own and make profit out of digital assets. The technology that enables these tokens has developed at a far greater pace than the law, creating a region of legal uncertainty. While there appears to be a lot of technical certainty and digital security, there exists a lot of blind spots in the legal domain concerning issues of copyright and intellectual property rights. The interpretation of the copyright act makes a clear distinction between token ownership and copyright ownership and just mere transfer of the token does not grant the buyer any exclusive rights, those rights are still vested with the original artist of the underlying work. Unless the artist grants these rights to the buyer of the token according to the provisions of the Copyright Act, they remain the owner of the copyright. Furthermore, the concept of ‘virtual digital asset’ is recognised under the Income Tax Act, but is only useful for taxation purposes and does not solve the underlying property question.

Bridging these gaps will require an in-depth legal analysis and assessment of the current NFT trading platforms. The laws that are presently in place can be aptly used to regulate physical assets, but fall short in dealing with virtual property and digital currency. An amendment to the copyright act that incorporates NFTs and provides clarity regarding token ownership and copyright ownership would be a crucial step forward in answering the question of what rights the buyers acquire. Until this issue is addressed, Indian buyers and the creators of the underlying work will have to operate on a platform that is technically safeguarded but legally questionable.

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