SLAUGHTER AND MAY/

NFTs: THE ESSENTIALS

From the Royal Mint to Madonna, it seems like everyone is issuing (or considering issuing) NFTs at the moment. But what are they, and what issues do you need to consider?

WHAT IS AN NFT?

NFT stands for 'non-fungible token'. A type of cryptoasset, NFTs are assets in their own right which are capable of being traded, but they are linked to, or represent, an associated asset (either a physical or, more commonly, a digital asset). They are often described as recording ownership, and seeking to validate authenticity, of that associated asset. Because of this, NFTs are sometimes thought of as digital certificates. However, what you actually 'get' with your NFT will depend on the terms which relate to it.

In practical terms, NFTs exist as a piece of code on a distributed ledger such as a blockchain, and are commonly governed by smart contracts. NFTs are regarded as non-fungible as each token has a unique number or ID which is tracked. This means that no two NFTs are identical – one is not equivalent to another and they are not mutually interchangeable in the way that fungible assets such as gold and (at least in theory) cryptocurrencies like bitcoin are (see our publication **NFTs: Digging Deeper** for further information).

WHEN ARE THEY USED?

NFTs are predominantely linked to digital assets such as digital artwork and Twitter avatars. This may be because, when functioning as a secure certificate of ownership, they introduce the possibility of having a 'unique' record of an asset, the origins of which can be traced on a blockchain. This (nominally) installs scarcity into an online environment and the potential for clear provenance. In addition, smart contracts can enable creators of associated digital assets to receive resale royalties. Beyond the digital world, NFTs have also been linked to tangible assets such as real estate, gold bullion and even Nike trainers.

> In 2021, crypto entrepreneur Sina Estavi bought an NFT of the world's first ever tweet ('just setting up my twttrr', by Jack Dorsey) for $2.9 million. In April 2022 he listed the NFT for sale at $48 million, but was disappointed by a top bid of just under $280.

SOME ISSUES TO CONSIDER

What do I actually own?

Ownership of an NFT gives you ownership of the specific token itself. As legal property, NFTs can be sold and traded for value on various marketplaces, such as OpenSea and Rarible. However, unless you expressly agree otherwise, you will not own any intellectual property in the associated asset. An NFT owner will therefore usually not be able to stop the original owner or others from exploiting (e.g. copying or distributing) the associated asset. Any rights to access and/or use should be set out in the terms and conditions applicable to the particular NFT. These vary from NFT to NFT, but are often limited (e.g. permitting only personal, non-commercial use). You therefore need to do your due diligence before buying an NFT. For example, does the person that minted (i.e. created) the NFT have the right to do so? What terms govern the arrangement (multiple terms may apply)? What rights are you getting? Where is the associated asset stored and how do you link to/access it (and ensure you maintain such access)? Security is also important, as hacking (e.g. of the encryption key which gives access to the NFT) is an issue.

Are NFTs within scope of financial regulation?

The definition of 'cryptoasset' is broad under the Money Laundering Regulations 2017, and so an NFT could fall within scope of the rules where it represents value or contractual rights. Where established, this could give rise to an FCA registration requirement if businesses or creators exchange NFTs for money or other cryptoassets like bitcoin.

Keep an eye on the financial promotions regime, which controls invitations or inducements to engage in investment activity, and which is going to be expanded to include cryptoassets. As currently consulted on, NFTs will be excluded from this regime, as only fungible cryptoassets will be captured. In addition, check that the NFT does not fall within the regulatory perimeter as a security token, e-money token or (the impending regulatory category of) 'digital settlement asset'.

> Bored Ape Yacht Club ("BAYC") NFTs are created on Ethereum using the standard ERC 721 contract form. Each BAYC NFT has a unique ID number and is itself property. However, each BAYC NFT also contains a link to an image of a distinct bored ape which is stored on the publically accessible InterPlanetary File System. The ape image is not the NFT, and it is not a part of the NFT (other than by the presence of a URL that directs to the image). However, the BAYC terms and conditions give the NFT owner certain rights to use the associated bored ape image.

Will it impact my ESG commitments?

NFTs mark a staging post in a longstanding conversation regarding blockchain's ability to optimise record-keeping processes and supply chain transparency, presenting opportunities in the context of social and governance outcomes. However, their reliance on blockchain technology making use of 'proof-of-work' consensus mechanisms has been criticised for its heavy energy consumption, which may impact any environmental commitments you have made. Other consensus mechanisms are, however, available. For example, Ethereum has announced that it is moving to a 'proof-of-stake' model.

Are there specific tax considerations?

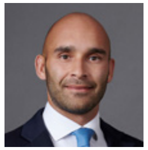
In short, yes. However, there is not one single, discrete tax regime that applies to NFTs, and determining the appropriate tax treatment will involve a case-by-case approach. The creation, transfer, and potential destruction of NFTs could have a number of tax consequences, including in respect of direct taxes, transfer taxes and value-added or sales taxes. Payments in respect of NFTs may also trigger withholding tax obligations in some circumstances. Critically, the tax treatment may not always follow the commercial perception of the transaction.

We understand that HMRC is developing guidance on the taxation of NFTs, to supplement its existing Cryptoassets Manual.

> For more information on NFTs and other Emerging Tech matters, please see our Digital blog '**The Lens**'.

CONTACTS

Rob Sumroy
Head of Tech, Privacy and Cyber
+44(0) 20 7090 4032
Rob.Sumroy@slaughterandmay.com



James Cook
Corporate, Head of Fintech
+44(0) 20 7090 4216
James.Cook@slaughterandmay.com

Natalie Donovan
PSL Counsel, Tech and Cyber
+44(0) 20 7090 4058
Natalie.Donovan@slaughterandmay.com

Emily Bradley
Senior PSL, Financial Regulation
+44(0) 20 7090 5212
Emily.Bradley@slaughterandmay.com

Richard Barker
PSL, IP
+44(0) 20 7090 4522
Richard.Barker@slaughterandmay.com