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Video Game NFTs: Top Legal Considerations for Developers

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The qualities of non-fungible tokens (NFTs), including digital scarcity, immutable persistence, and transferability on a blockchain, make NFTs an attractive technology to integrate into video games. NFTs have been implemented into video games as in-game assets, transferable characters, and even as a means of rewarding players with cryptocurrency, and the recent success of Web3 games will likely lead to more games incorporating NFTs and related blockchain technologies. Before utilizing NFTs, video game developers should consider what rights are being granted when designing NFTs, as the mechanics of the NFTs may have legal, economic, and possibly regulatory ramifications.

Here are some key considerations for video game companies that are interested in integrating NFTs into their games:

1. NFTs as a Basket of Rights

Despite its ubiquity, the term “NFT” does not have a universally agreed-upon meaning and has yet to be defined by any US regulatory body. From a technical standpoint, an NFT is a set of code or data that is recorded and stored on a blockchain. In the video game context, the NFT’s data typically represent an underlying digital asset such as digital art, videos, a character, items, or even a plot of virtual land. Just as the form and function of NFTs can vary widely, so too can the rights granted to a game player that acquires an NFT.

From a legal standpoint, an NFT should be thought of as a basket of rights bestowed upon the NFT holder rather than a singular piece of acquired property. The scope of the acquired rights is determined by the NFT developer and how it designs and transfers or sells the NFT. For example, purchasing an NFT that represents digital art often does not transfer all of the underlying intellectual property rights in the digital art to the NFT purchaser; rather, purchasing the NFT usually grants the purchaser limited rights in the underlying digital art, such as the right to use, copy, and display the artwork. In some cases, purchasing an NFT may not include a grant of any intellectual property rights in the underlying digital content—some digital collectible NFTs only give the owner the right to resell the NFTs, with no rights to use or display the underlying copyrighted content, which is owned by a third party. Further, some NFTs grant the NFT holders economic rights, such as the right to receive a percentage of the sales of other NFTs in the same collection.

Purchasing or acquiring an NFT in a video game can mean different things for different games. Video game developers can (and should) limit or expand the rights associated with NFTs to meet their needs. Oftentimes in the video game context, players will “purchase” or “own” an NFT via the functionality of the game, but that ownership really means that the player has only acquired a right or license to (i) sell the NFT on third-party marketplaces, or (ii) use the underlying digital asset (such as a unique cosmetic item) in the video game.¹ For example, Ubisoft launched its Quartz platform on the Tezos blockchain in December of 2021, which allows players to acquire NFTs of cosmetic in-game items that can be used in the PC game Tom Clancy’s Ghost Recon.² While players can “own” the Ghost Recon NFTs, they can only

use the item in the game or transfer it to other Ghost Recon players on the Rarible³ or Objkt⁴ marketplaces, and they have no rights to the underlying intellectual property.⁵ Thus, while NFT holders may be able to point to their name on a blockchain and say that an NFT is theirs, in actuality, the rights they “own” in the NFT may be something less than the traditional notion of ownership.

Video game developers that integrate NFTs into their games should (i) carefully consider what rights they want to grant to players that acquire in-game NFTs, and (ii) make it clear to the players exactly what rights they get (and don’t get) when they purchase or otherwise acquire an in-game NFT so that there is no confusion about what the NFT acquiror can or cannot do with the NFT.

2. Intellectual Property Issues Related to In-Game NFTs

If an NFT contains any of the game developer’s own intellectual property (such as branding or proprietary characters), the developer should determine to what extent it wants to license out or retain rights in that intellectual property, and conversely, whether the in-game NFT acquiror may need to obtain certain rights in the NFT’s underlying intellectual property. For example, if the NFT is an in-game item, the player needs to be granted the right to actually use that item (including any intellectual property rights in the underlying NFT digital asset) in the game. Further, to the extent game developers retain rights in an NFT, they will want to consider an approach to addressing third-party infringement, and create a plan for how they will police copycat NFT projects, which are common in the space.⁶

Developers should also consider what intellectual property rights they have (or need to acquire) in the underlying digital asset before creating NFTs. For example, developers creating NFTs from licensed brands or other third-party intellectual property should ensure their in-bound brand or other license agreements give them rights that cover the entire lifespan and intended functionality of the NFTs. Such developers would likely need licenses that grant them express, irrevocable, and transferable rights to use the licensed third-party content in-game and (if applicable) off-platform in connection with the NFTs.

Video game developers that integrate NFTs into their games should ensure that they have acquired all third-party and other intellectual property rights that are necessary in order for the video game developer to integrate the underlying NFT digital content into

the video game, including by entering into third-party intellectual property license agreements that specifically contemplate and allow for the use of the third-party intellectual property within the game's NFTs.

Video game developers should also include NFT-specific terms in their games' terms of use or other agreement that users must agree to before acquiring NFTs. Such terms should, in addition to providing other important, standard contractual protections of the developer, set forth (a) the rights granted to NFT acquirors, (b) restrictions on how the NFT may be used, (c) penalties for violations of the NFT use restrictions, and (d) liability protections against claims made against the developer for unauthorized use of the NFT by the NFT acquiror.

3. Regulatory Risks

Though regulators have provided limited guidance on NFTs, many existing federal and state laws, including securities laws in foreign jurisdictions, particularly those governing the financial industries, can apply to NFTs, blockchain technologies, cryptocurrencies, and tokens.

As common with most cryptoassets, NFTs are highly customizable by the game developer. NFT developers must be cognizant of the applicable state and federal securities regulations when designing the structure of their NFTs. Though not traditional "securities", NFTs found to be "investment contracts" will be deemed to be "securities" by regulators. In *SEC v. Howey*, the US Supreme Court developed a four-part test for whether an asset is an "investment contract": the asset must involve an (1) investment of money in a (2) common enterprise with (3) an expectation of profit (4) primarily derived from the effort of others.⁷

In *Howey*, plots of land in an orange grove were deemed securities because buyers purchased, in addition to the land, a suite of management services that were integral to the success of the investment—including services related to cultivating the land and harvesting, marketing, and selling the fruit, none of which buyers could do themselves, as almost all were passive investors far from the land in question. By extrapolating *Howey's* facts to NFTs, one can see how an NFT could become an investment contract and thereby a security.

Though the *Howey* test is dependent on facts and circumstances, developers must be careful in the structuring of NFTs to ensure their characteristics do not cause the NFT to become a "security", subjecting it to the applicable securities laws. Once deemed a security, offering, selling, and transacting in the NFT

will trigger the various securities laws, including, among others, laws requiring that securities offerings are registered with the Securities and Exchange Commission (SEC) or that entities facilitating secondary trading in securities register as exchanges or alternative trading systems. If securities regulations are violated, there are potentially significant consequences ranging from monetary penalties to imprisonment. Consequently, it is imperative that developers consult with legal counsel prior to the launch of their NFTs to ensure that they do not run afoul of securities regulations.

The *Howey* test is incredibly fact dependent, and can depend on the manner of distribution and marketing of tokens, actions taken by creator of the NFTs, and expectations of the NFT purchasers. Therefore, developers who have been considering combining NFTs with economic rights (like revenue sharing or entitlements to future tokens or other expectations for appreciation of value) would be wise to work with legal counsel to design NFT products to ensure that they are not securities under the *Howey* test. Additionally, there are other financial regulatory regimes, such as those governing commodities or money transmissions, that could also be applicable and accordingly should be consulted upon as well.

At the end of the day, NFTs, like tokens, are simply code. The real questions relate to whether the business surrounding the NFT will create a security under the *Howey* test. Developers must continually ask themselves the four questions posed in *Howey* to avoid their NFTs becoming securities.

Video game developers should consult with legal counsel prior to the launch of different types of NFTs to ensure that they do not run afoul of securities and other regulations.

4. Tax Treatment

The tax implications of in-game NFTs for gamers and game developers in the United States is unclear, and both purchases and sales of in-game NFTs might result in unexpected (and very real) tax bills.

The Internal Revenue Service, or IRS, has not issued any specific guidance on taxation of NFTs or tax reporting of NFT transactions (in general and in the video game context). Many tax practitioners believe that the tax treatment of NFTs would be similar to the tax treatment of cryptocurrency (e.g., Bitcoin, Ethereum), which is generally treated as property for tax purposes.⁸ For purposes of this alert, we assume that NFTs are treated similar to cryptocurrency for US tax purposes and are bought and sold for

a cryptocurrency that is exchangeable into regular, fiat currency, such as US Dollars. Based on existing IRS guidance regarding cryptocurrency, each NFT transaction could potentially result in multiple taxable events, each of which would need to be reported to the IRS. Below are some common scenarios.

- **Initial creation and sale of an NFT.**
 - Although the act of minting an NFT is generally not considered a taxable event in itself, the act of selling the NFT is. The proceeds from the first sale of an NFT by its developer or artist is considered revenue, and the profits of such sales would be taxable as ordinary income.
 - A purchaser who uses cryptocurrency to buy an NFT would generally recognize capital gain or loss on the disposition of such cryptocurrency, which may be eligible for a long-term capital gains rate if the cryptocurrency used has been held for more than a year. If the cryptocurrency has been held for a year or less, any gain will be taxed at short-term capital gains rate (generally, the same as ordinary income). The purchaser's basis in the NFT will equal its fair market value on the date of purchase, and the purchaser's holding period in the NFT will start on the day after the day of purchase.
- **Subsequent resale of an NFT.**
 - Assuming an NFT is held as a capital asset (generally, property held for appreciation, not as inventory for resale to customers), the gain recognized upon a sale of the NFT by the seller will be taxed at the applicable capital gains rate. However, the IRS may argue that the transaction should be taxed as a sale of collectibles, with a higher tax rate (currently, up to 28% for individual taxpayers) if the asset is held longer than one year. If the sale results in a loss, a person's ability to use the loss to offset other income is subject to limitation.
 - Purchasers who dispose of cryptocurrency to acquire an NFT would have a taxable disposition as described above.
- **Exchange of an NFT for another NFT.** Both parties to the exchange would recognize gain or loss on the transaction, equal to the applicable fair market values of the NFTs, less the party's basis in the NFT for tax purposes. Such gain will be subject to tax at the applicable short-term or

long-term capital gains rate. It may be difficult to determine the fair market value of the exchanged NFTs and how to substantiate it for tax purposes.

To add additional complexity for gamers, many NFT platforms and video games do not automatically track users' cost basis of and transactions with NFTs, which means NFT creators and owners must keep and maintain extensive personal records to support their tax positions. Developers of video games involving NFT trades should also consider whether they might be required to file information returns with the IRS or other taxing authorities in connection with in-game NFT trades. For example, the recently enacted legislation commonly known as the Infrastructure Investment and Jobs Act (the "Act") added required information reporting for certain transactions with "digital assets" exceeding \$10,000, defined broadly as "any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary [of the Treasury]", which may include NFTs.⁹ Further, game developers may be treated as "brokers" under the Act and required to file Form 1099-Bs for transactions with cryptocurrencies and NFTs.¹⁰

Finally, it is unclear how NFT sales will be treated for state tax purposes. For example, some states impose sales tax on the sale of digital goods, and it is possible that these laws would apply to the sale or exchange of NFTs. In such case, it is also not clear who would need to collect and remit such tax.

Video game developers and creators and purchasers and sellers of NFTs should consult with their tax advisors regarding the tax implications of creating, purchasing, selling and exchanging NFTs.

5. Conclusion

NFTs present a unique, exciting, and revolutionary addition to the video game industry, and the possibilities are limitless. We at Wilson Sonsini Goodrich & Rosati aspire to enable developers to integrate these types of innovative technologies into their business by counseling our clients on how to intelligently navigate these novel and ever-evolving legal issues. Please do not hesitate to contact a member of your Wilson Sonsini corporate, securities regulatory and complex transactions, or technology transactions team for more information on the creation and issuance of cryptoassets and NFTs in video games.

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1. See Ubisoft, *Ubisoft Quartz Terms of Use*, <https://legal.ubi.com/ubisoft-quartz/terms/en-US> (last updated Dec. 7, 2021).
 2. Ubisoft, *Ubisoft Quartz*, <https://quartz.ubisoft.com/welcome/> (last visited Jan. 30, 2022).
 3. Rarible, <https://rarible.com/>.
 4. Objekt, <https://objkt.com/>.
 5. *Id.*
 6. See Lawrence Carrel, *As NFT Scams Grow In Number, NFT Insurance Hits the Market*, FORBES (January 28, 2022), <https://www.forbes.com/sites/lcarrel/2022/01/28/as-nft-scams-grow-in-number-nft-insurance-hits-the-market/?sh=4554a2047bcb>; See also Adi Robertson, *Two NFT Copycats Are Fighting Over Which is the Real Fake Bored Ape Yacht Club*, THE VERGE (Dec. 30, 2021), <https://www.theverge.com/2021/12/30/22860010/bored-ape-yacht-club-payc-phayc-copycat-nft>.
 7. *Howey*, 328 U.S. at 299. See also *SEC v. Glenn W. Turner Enterprises Inc.*, 474 F.2d 476, 482 (9th Cir. 1973) (broadening the *Howey* requirement that profits be earned “solely” from the efforts of others to “primarily”).
 8. See, generally, IRS Notice 2014-21, Rev. Rul. 2019-24. For more information, see WSGR Alert, *IRS Issues Guidance for Transactions Involving Virtual Currency*, available at <https://www.wsgr.com/en/insights/irs-issues-guidance-for-transactions-involving-virtual-currency.html>.
 9. Internal Revenue Code of 1986 (as amended by the Infrastructure Investment and Jobs Act (P.L. 117-58)), Sections 6050I(d)(3) and 6045(g)(3). IRS is expected to release further guidance in this area.
 10. *Id.*, Sections 6045(c)(1), 6045(g)(3)(B).



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