

Legal Challenges in Using Blockchain Technology in Securing Royalties for Artwork

Blockchain technology revolutionizes artwork royalty security through smart contracts and NFTs, but navigating its legal implication remains complex.



The integration of Artificial Intelligence (AI) in art and creative sectors brings forth both opportunities and challenges, which calls for a thorough understanding of the legal framework to ensure compliance and safeguard intellectual property. This article delves into the role of blockchain in securing artwork royalties and its impact on taxation.

Virtual assets (VAs) and crypto-assets, synonymous terms, refer to digital assets issued or transferred through distributed ledger or blockchain technology. Blockchain technology emerges as a robust solution for safeguarding art by establishing a transparent and unchangeable record of ownership and provenance. By leveraging blockchain, artists can retain control over their work and receive royalties from subsequent sales through smart contracts, promoting fairness and transparency in the art market.

The use of means such as Non-Fungible Tokens (NFTs) are reshaping the balance of power, shifting it from intermediaries back to artists and creators. With blockchain's incorporation in NFTs, tracking royalties and direct payments to artists become feasible, allowing for continuous benefit when their art is commercially disseminated. This alteration in business models within creative industries signifies a substantial change, offering artists ongoing compensation for their work.

Across three distinct categories of art, the integration of blockchain technology and NFTs presents transformative opportunities.

For physical art, the traditional method of verifying authenticity involves costly engagement with experts. Blockchain technology facilitates transparency by enabling investors to trace the transactions back to the original creator, ensuring ownership verification. Tokenization of assets has the potential to reshape market operations, with smart contracts embedded in NFTs specifying royalties for artists.

For digital art, creators from various fields can benefit significantly from music to works of art. Blockchain serve as ownership certificates, allowing for continuous tracking of artwork ownership and engagement with owners through post-sale content.

For AI-generated art, copyright ownership complexities are addressed through contractual agreements, which may involve developers, operators, or users of AI systems. These agreements clarify ownership rights, potentially granting AI-system owners copyright while providing users with non-exclusive licenses.

Financial Regulatory Framework

In Hong Kong, while engagement with blockchain technology is permissible, activities revolving around cryptocurrencies and virtual assets may face regulatory restrictions stipulated by local laws. The Securities and Futures Ordinance (SFO) serves as a pivotal regulatory framework governing these operations. Certain crypto assets, notably Non-Fungible Tokens (NFTs), could be classified as "securities" under the SFO if they promise returns, profits, or equity interests.

Regulatory oversight extends to marketing and selling securities, including dealings in securities as a regulated activity under the SFO. The Securities and Futures Commission (SFC) mandates licensing for individuals involved in these activities, unless exempted. Additionally, under the new Anti-Money Laundering and Counter-Terrorist Financing Ordinance (AMLO) regime effective since June 2023, activities may require licensing even if virtual assets (VA) do not qualify as "securities".

Hong Kong adopts a risk-based, prudent approach towards VAs, as illustrated by the SFC's licensing system for Virtual Asset Trading Platform (VATP) operators introduced in June 2023. The Government's commitment to enhancing the regulatory framework for VAs is evident in the Policy Statement on Virtual Assets (VAs) released in October 2022 and the formation of a Task Force on Promoting Web3 Development in June 2023.

To support sustainable growth in the stablecoin ecosystem, the Hong Kong Monetary Authority (HKMA) launched the stablecoin issuer sandbox in March 2024. Institutions planning to issue stablecoins can leverage this sandbox to test operational strategies and engage in discussions on proposed regulatory standards. In July 2024, the Financial Services and the Treasury Bureau, in collaboration with the HKMA, published consultation conclusions on a legislative proposal to regulate fiat-referenced stablecoin issuers in Hong Kong. The anticipated licensing regime for FRS issuers aims to further fortify Hong Kong's VA regulatory framework.

Intellectual Property Rights

For physical and digital works of art, copyright infringement may present in 2 primary forms due to the unauthorized minting of a digital asset.

Firstly, the reproduction right infringement involves the replication or copying of copyrighted works. Should a VA or NFT include a digital copy of the asset, it could constitute unauthorized reproduction and thus infringe upon copyright. However, if there is no reproduction of the underlying asset during its creation, there might be no infringement.

Secondly, the communication right infringement pertains to the dissemination of copyrighted works to a new audience not initially foreseen by the copyright owner. Minting a VA or NFT linked to an underlying asset can be viewed as a distinct action from presenting the asset in a new setting. Nevertheless, if the VA or NFT contains a digital copy of the asset, minting it could qualify as communication to a new audience not originally anticipated by the copyright holder.

Presently, there are more queries and debates than definitive answers on these matters. The resolution will hinge on the specific circumstances of each case and any policy considerations a court might weigh.

Thirdly, trademark infringement could occur when an unauthorized party mints a VA or NFT associated with an underlying asset without the asset owner's consent, and then promotes, offers for sale, or sells the VA or NFT employing the asset owner's registered trademarks. The critical aspect to assess is whether the business possesses registered trademarks that encompass VAs, NFTs or similar goods/services. If so, establishing a case for trademark infringement under trademark law may exist if the identical mark is utilized as the asset owner's registered trademark for identical goods or services, or if the same or similar mark is employed as the asset owner's registered trademark in connection with the same or similar goods, leading to a likelihood of confusion. Even if the asset owner lacks trademarks for pertinent goods/services, a case might still be plausible, under specific circumstances, to argue that utilizing the same or similar mark for dissimilar goods unfairly leverages the reputation of the asset owner's registered trademark, thereby constituting infringement.

For AI-generated artworks, Hong Kong's copyright regime, similar to the UK's, extends protection to computer-generated works, including those created by AI. This means that AI-generated literary, dramatic, musical, or artistic works (LDMA works) without human authorship are protected for a shorter duration of 50 years from creation, with limited moral rights. Other non-LDMA works, such as sound recordings and films, enjoy equal copyright protection regardless of whether they are human or computer-generated.

In the 2024 consultation "Copyright and Artificial Intelligence", Hong Kong lawmakers have recently expressed concerns over proposed safeguards for copyrighted works used in AI training. A government-proposed "opt-out" mechanism aims to protect copyrighted works from being used in AI model training, introducing a new copyright exception to permit reasonable use of text and data mining (TDM) activities for both commercial and non-commercial purposes. This exception would enable AI developers to utilize copyright-protected works as training data under specific conditions without prior authorization. This highlights the ongoing debate about balancing copyright protection with the need to facilitate AI innovation. The government has proposed a "text and data mining (TDM) exception" to allow for the reasonable use of copyrighted works in AI training, which could help strike this balance.

Liability and Arbitration

The current legal framework is flexible, allowing infringement cases to be assessed on a case-by-case basis, with liability often dependent on specific circumstances.

Blockchain technology, while promising for authenticating artworks and securing intellectual property rights, faces technical and legal limitations. Despite its potential for tracking ownership and provenance, blockchain is not foolproof. Cases of NFT theft and disputes over intellectual property rights highlight these vulnerabilities. The immutability of blockchain, beneficial for tracking ownership, can also limit artists' control over their NFTs once minted, as they cannot be removed to prevent unauthorized use in AI model training. The government acknowledges the role of contractual arrangements in managing risks and liability allocation but seeks views on whether specific legal reforms are necessary to clarify ownership and usage rights for content. The risk of rigid liability rules leading to unfair outcomes is also under consideration. As blockchain technology continues to evolve, it is crucial for Hong Kong to balance innovation with legal clarity to ensure that artists' rights are protected effectively.

Hong Kong stands out as an ideal arbitration venue for resolving crypto-related disputes since the jurisdiction recognizes cryptocurrency as property, allowing for legal enforcement actions such as injunctions. Additionally, Hong Kong law confirms that intellectual property disputes are arbitrable, covering a wide range of issues related to cryptocurrencies, NFTs, and blockchain technologies. The pro-arbitration judiciary respects arbitration agreements and limits intervention, while also upholding principles of fairness and impartiality. Parties have access to flexible interim measures, including those granted by emergency arbitrators, tribunals, or courts, ensuring asset and evidence preservation.

Smart Contracts and Royalty Payments

A smart contract functions as a code that enforces a specific set of conditions essential for a trade to be executed; should any condition fail, the trade is invalidated. By integrating blockchain smart contracts into

the process of transferring ownership of their creations, artists can incorporate resale royalties as a prerequisite for title transfer, guaranteeing them a percentage of any future sales automatically.

Artists have long sought a more equitable art industry, and now, technology exists that can assist in advancing this objective. The utilization of blockchain smart contracts helps rectify the power dynamics with concerns that blockchain might displace galleries, curators, dealers, and other intermediaries. However, this apprehension undermines the genuine value that these stakeholders bring to the art ecosystem.

Taxation

Creating or minting an NFT or other digital intangible asset does not trigger a taxable event; however, selling these creations does. The tax implications become particularly intricate when considering the jurisdiction of the creator, the storage location of the asset data, and the subsequent sale of these assets. Besides direct taxes, these income streams may be subject to indirect taxes (such as VAT). However, most tax authorities don't have clear regulations around this (yet).

Creators typically generate income in 2 ways: first, through the initial sales of the VA or NFT to the first buyer, and second, through recurring income from subsequent resales, akin to royalties. The tax treatment of these income streams depends on the creator's location and the respective domestic laws governing income tax. Moreover, transactions involving VAs or NFTs often occur using cryptocurrencies, which many jurisdictions classify as assets rather than currencies. Any gains realized from exchanging cryptocurrencies for other assets, including NFTs, are taxable. This extends to trading one NFT for another, which also falls under taxation. For instance, if you purchased Ethereum for \$10,000 and later used it to buy an NFT valued at \$15,000, resulting in a \$5,000 gain, you would be required to pay Capital Gain Tax on that profit. Conversely, if the value of your Ethereum has decreased since acquisition, you would incur a capital loss, which could potentially offset other gains and reduce your overall tax liability.

In jurisdictions where capital gains are distinct from trading gains or are tax-exempt, it becomes crucial to characterize NFTs from the buyer's perspective. Additionally, in territories with a territorial tax system, determining the income source from subsequent sales can pose challenges.

The taxation of gains (and losses) arising from digital assets hinges on the type of assets and their business utilization. For instance, the Inland Revenue Department (IRD) in Hong Kong classifies crypto assets into 3 categories: payment tokens (e.g., Bitcoin), security tokens (providing ownership interests, such as a debt or a right to a share in the profits of the business), and utility tokens (granting the holder with access to goods or services, whereby the issuer of the utility tokens normally commits in the future to accepting the tokens as payment for goods and services).

<i>Type of Tokens</i>	<i>Tax treatment</i>
Initial Coin Offerings (ICOs)	<p>Primarily determined by the nature of the tokens issued rather than the purpose of the funds raised, the Inland Revenue Department (IRD) assesses ICOs by examining the white paper and underlying documentation to discern the rights and benefits linked to the digital tokens, such as equity interests or future service access akin to vouchers.</p> <ul style="list-style-type: none"> • Proceeds from the offering of security tokens are often treated as capital and non-taxable. • Proceeds from the offering of utility tokens can be viewed as prepayments for goods or services and taxable if sourced in Hong Kong.
Digital Asset Investment	<p>Proceeds are typically tax-exempt when treated as capital assets.</p> <p>However, if digital assets are used in trading, exchanging, or mining activities, only profits sourced in Hong Kong are subject to profits tax. This is a question of fact,</p>

	having regard to degree, frequency of activity and level of system and organization, and whether the purpose of the activity is in fact to make a profit.
Cryptocurrency	<p>Profits from Hong Kong-based cryptocurrency activities are subject to profits tax, considering factors such as frequency, purpose and organization level of the activity.</p> <p>For the treatment of unrealized gains/ losses from the year-end revaluation of the digital assets used for the purposes of carrying a cryptocurrency business, the treatment should depend on the nature of the digital assets (whether capital or revenue), and to the extent that they are revenue in nature. Applying the general principle that unrealized gains from the increase in value of trading stock are not chargeable to tax at the time they are accounted for, but should instead be taxed at the time of realization (<i>Nice Cheer Investment Limited v. Commissioner of Inland Revenue</i>), subject to the application of the Inland Revenue (Amendment) (No. 2) Ordinance 2019 where the taxpayer can elect to be taxed on a fair value basis in respect of financial instruments shall the digital asset be accounted for in accordance with the Hong Kong Financial reporting Standards (HKFRS).</p>

In March 2020, the IRD released an updated version of Departmental Interpretation and Practice Note No. 39, incorporating a new section on digital assets. The Practice Note outlines that the tax treatment of digital assets is contingent upon their characteristics and intended use.

In Hong Kong, specific guidelines for taxing ventures related to cryptocurrencies are currently lacking. The IRD typically applies standard business taxation rules to digital assets and cryptocurrency businesses. Critical factors in this assessment include determining the location of the trade, whether profits originate from or within Hong Kong, and whether the gains are categorized as capital-related.

Disputes frequently arise between the IRD and taxpayers regarding these factors, often leading to tax cases being brought before the Board of Review and courts for resolution. It's important to note that individuals, not just entities, can be subject to Hong Kong tax on investment revenue if specific criteria are met.

Navigating these considerations, particularly concerning income derived from intangible assets such as NFTs, crypto assets, or cryptocurrencies traded online, presents challenges due to the absence of clear guidelines. Consequently, each situation often requires a thorough case-by-case evaluation to determine the appropriate tax treatment.

We provides legal guidance on the use of blockchain technology to secure and automate royalty payments for artwork. Our team advises on smart contract design, copyright compliance, and regulatory considerations to help creators and platforms implement legally sound royalty distribution mechanisms.

To learn how JML can support your blockchain-based royalty solutions, scan the QR code below for direct access to our services.



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