

Crackdown on digital art

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In March last year digital artist Mike Winklemann, better known as ‘Beeple’, sold a composite of 5,000 of his daily drawings, titled *Everydays: The First 5,000 Days*, as a non-fungible token (NFT) at a Christie’s auction for a record-breaking US\$69m.

An NFT is a unique, verifiable proof of ownership for anything in a virtual form, including digital formats for art, music, videos, objects in a video game, and other pieces of creative work (although NFTs are by no means restricted to the creative arts). An NFT is a unique code which is stored on protected online servers which can also be public marketplaces. While NFTs in the art world are essentially digital artworks and have the same traits as conventional art, they also have the benefit of being fully digital.

Trading in NFTs usually results in an informal exchange of ownership over an asset which does not have a legal basis for regulation or enforcement. While NFTs function much like cryptographic tokens, they are not mutually interchangeable (since a unique work of art is not directly exchangeable with another piece of art) and hence not fungible.

The challenges

While the exchange rate of cryptocurrencies to conventional money follows market principles of supply and demand, the prices of NFTs are highly speculative. Further, although blockchains maintain an audit trail to trace NFT transactions between online wallets, without a detailed documented and audited identity check (KYC) of the wallet holder it’s easier than ever to transfer value completely anonymously.

For these reasons, the US Treasury Department’s Financial Crimes Enforcement Network has stated that the emerging digital art market poses a significant money laundering and financial crime risk (see boxout). In a report, it cites cases where the vulnerabilities of that market have been exploited, including Malaysian businessman Jho Low’s 1MDB scheme, where illicit proceeds were transferred through ‘gifted’ artworks, and manipulated art valuations were used to obtain under-collateralised loans.

Regulatory responses

Considering the risks associated with NFTs (potential fraud, intellectual property theft, tax evasion and money laundering), governments around the world are looking at ways to regulate digital currencies and NFTs. Nations have adopted vastly different positions on the regulatory framework to tackle the threat and risks posed by cryptocurrencies and NFTs according to the socio-economic challenges, political discourse, characterisation of NFTs, and outlook on digital currencies.

The European Commission recently issued a proposal to regulate crypto-assets – the Markets in crypto-assets Regulation (MiCA). MiCA classifies a crypto-asset as a ‘digital representation of value or rights which may be transferred and stored electronically, using distributed ledger technology or similar technology’. It’s a definition that partially includes NFTs. At the time of going to press, the European Parliament has adopted the proposals, which will now be implemented through detailed regulations. EU member states are also at various stages of issuing domestic regulations that specifically address NFTs.

In the UK, HMRC seized three NFTs as part of a suspected case of VAT fraud worth £1.4 m in the first ever domestic enforcement action of this kind, in February 2022.

NFTs have also drawn significant regulatory scrutiny from multiple US state and federal agencies. The primary reason for this is that the existing regulatory and legal environment is not designed to manage the creation, licensing and trade in NFTs and other digital assets.

In its recent annual Budget, India introduced taxing rights for cryptocurrency for the first time, with any income earned from transferring any virtual digital assets taxed at a flat rate of 30%. India has also introduced a 1% withholding tax on all digital asset transactions. This will give Indian tax authorities a database of crypto investors and details of transactions to regulate crypto markets.

Dubai has passed a law governing virtual assets and established a regulator, the Dubai Virtual Assets Regulatory Authority (VARA), to oversee the regulation, licensing and governance of virtual asset platforms. The legislation is meant to provide a regulatory framework for businesses dealing with cryptocurrencies in various formats including security tokens and NFTs. Activities such as operating and managing virtual asset platforms, exchange between virtual assets and currencies, virtual asset transfer services, and services related to the virtual asset portfolio will all require VARA authorisation.

Future trends

Specialist research agency NFTgo recently valued the NFT industry at around US\$16bn. Given the complexities in dealing with NFTs, it appears inevitable that governments will issue strict guidance on how NFTs should be treated for tax and regulatory purposes – that is, whether they should be treated as securities, currencies, collective investments, financial instruments or something entirely different.

NFTs’ rapid popularity has caused governments around the world to increase scrutiny to protect citizens and collect their fair share of related revenue. Without a robust regulatory framework and strict regulations in place, there remains an increased risk of illegal activities such as tax evasion, money laundering, terrorist financing, fraud and theft. NFTs have the potential to disrupt existing and emerging technology sectors and drive commensurate opportunity and risk.

What’s in the frame?

Several qualities make NFTs in the high-value art market vulnerable to manipulation, including:

- the relatively high value of art compared with other retail goods and commodities
- the historically opaque nature of the high-value art market
- subjective valuations and the lack of stable and predictable pricing
- the transportability of certain types of artworks, including across international borders
- the difficulty faced by law enforcement to monitor such movements and assess the value of artwork, including across borders
- the accepted use of third-party intermediaries to purchase, sell and hold artworks while their clients remain anonymous (ie art dealers, advisers, interior designers, shell companies, trusts).

Source: FinCen

More information

Read the US Treasury's *Study of the Facilitation of Money Laundering and Terror Finance Through the Trade in Works of Art*

ACCA's anti-money laundering resource hub is [here](#)