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Expert Q&A on Cryptocurrency Compensation

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An expert Q&A with Nyron Persaud and Mary Lewis of Cooley LLP on using cryptocurrency to compensate employees and other service providers. The experts focus primarily on token-based awards, addressing how they compare to traditional equity-based awards, the most common types of token-based awards, tax and securities laws considerations, and administrative challenges. The experts also address obstacles to paying wages in convertible digital currency and why defined contribution plan fiduciaries must exercise caution before adding cryptocurrency investment options to their plans.

An increasing number of employers, both in and outside of the Web3 universe, are exploring the idea of using digital assets, including token-based awards and cryptocurrencies, in their compensation packages.

While certain employees and other service providers may prefer to be paid in a digital currency such as Bitcoin, a legal and regulatory framework for paying wages in virtual currency has not yet been established. This raises issues for employers who must comply with federal, state, and local employment laws. For example, employers must comply with the overtime and minimum wage requirements of the Fair Labor Standards Act (FLSA) under which monetary payments generally must be in the form of cash or a negotiable instrument, such as a check.

There is also significant trepidation about including cryptocurrencies in 401(k) plans, prompting the US Department of Labor's Employee Benefits Security Administration (EBSA) to publish a release in March 2022 cautioning defined contribution plan fiduciaries to "exercise extreme care" before adding cryptocurrencies as investment options for their participants.

Token-based awards have gained traction in the area of incentive compensation for companies in the Web3 industry. Token-based awards generally mimic traditional equity compensation awards, and like traditional equity-based awards, may be issued to employees and other service providers under an incentive plan, with specific terms set out in individualized award agreements. They are also typically structured to comply with the same tax and securities laws considerations as traditional equity awards. But administering, tracking, and recovering tokens raise new challenges.

Overall, whether or not it makes sense for an employer to make token-based awards and cryptocurrencies part of its compensation package depends on several factors, including:

- Applicable wage and hour laws, and the administrative complexities they present.
- The composition of the employer's workforce, including its appetite for, and understanding of the risks related to, being paid in cryptocurrency or granted token-based awards or making investments in tokens.
- The employer's ability to address challenges, such as:
  - valuation;
  - price volatility;
  - recordkeeping;
  - the speculative nature of cryptocurrency investments; and
  - the evolving regulatory landscape.

Practical Law asked Nyron Persaud and Mary Lewis of Cooley LLP to address a number of important threshold considerations related to crypto-based compensation:

What are Tokens?

With the increased adoption of blockchain technology, many employers in the Web3 space involved with developing blockchain-based token networks are incentivizing their founders, employees, directors, consultants, and other service providers through the grant of token-based awards which relate to the digital network being developed by these employers. These tokens reflect ownership of digital assets within a given protocol or token network. While the allocation of tokens may be proportional to the underlying equity ownership structure of the employer, the token-based awards are separate from traditional equity interests. Rather than being reflected on a share ledger, these tokens are stored on a digital or distributed ledger. Certain distributed ledgers allow users to secure the tokens via embedded scripts of computer code into the ledger that execute automatically if the conditions in the script are satisfied. These scripts are known as smart contracts. For more information on blockchain and distributed ledger technology, see Practice Note, Blockchain and Distributed Ledger Technology (DLT) Overview.

Token Incentive Plans and Awards

What is a token incentive plan?

A token incentive plan is a form of incentive compensation plan, similar in some respects to a traditional equity incentive plan, under which a company can grant token-based awards to:

- Employees.
- Directors.
- Consultants.
- Other service providers.

Token incentive plans often include a variety of award types, including:

- Fully vested tokens.
- Restricted tokens.
- Restricted token units (also referred to as RTUs or future token interests).
- Other awards denominated in, or the value of which is based on or relates to, tokens.

Each type of award is governed by the terms of the incentive compensation plan and an individualized award agreement setting out the terms and conditions applicable to each award.

What are the most common award types under a token incentive plan?

Currently, the two most common awards are restricted tokens and RTUs.

What are the differences between restricted tokens and RTUs?

In many ways, the distinction between restricted tokens and RTUs mirrors the distinction between restricted stock and restricted stock units (RSUs) in the traditional equity context. Both awards are full value rights, representing an interest in the full value of a token (not just the value of appreciation from the time of grant). Both awards are also commonly subject to time-based or performance-based vesting conditions and lock-up restrictions following the grant date. However, the two differ in that:

- Restricted tokens are actual tokens, transferred to a service provider's digital wallet, and are commonly secured via a smart contract designed to send, receive, and, if applicable, temporarily restrict further transfer of tokens following the grant date and until the vesting and forfeiture conditions have been satisfied.
- RTUs represent a contractual obligation to transfer tokens in the future. Tokens are not actually transferred to participants until vesting conditions set out in the award agreement are satisfied.

What are the advantages of restricted tokens vs. RTUs?

Restricted tokens can be a tax-efficient vehicle for early-stage companies. Recipients of restricted token awards may file an election under Section 83(b) of the Internal Revenue Code (an 83(b) election) to take the value of the tokens into account for ordinary income tax purposes at the time of grant rather than at the time of vesting. Because the full value of a restricted token award can be taken into income at the time of grant, the recipient does not incur any additional taxation until they transfer the tokens (following the lock-up and vesting periods). Any gain at the time of the transfer is eligible for capital gains tax treatment, which may be short-term or long-term depending on how long the tokens have been held. Because of the one-year lock-up following issuance (see Are tokens subject to other transfer restrictions?), many restricted token awards are eligible for long-term capital gains treatment. Like restricted stock, there is always a risk that if the value of the tokens decreases following the filing of an 83(b) election, the recipient will experience a capital loss. Accordingly, restricted token grants may be attractive for early-stage companies if the value of the tokens is relatively low at the time of grant and the tokens have significant appreciation potential following the grant date.

For more mature companies with a higher token valuation, RTUs may be a better choice. In the case of RTUs, the recipient will recognize ordinary income tax if and when the tokens are transferred to the recipient's digital wallet following vesting. To avoid the application of Section 409A, companies may rely on Section 409A's short-term deferral exception, under which calendar-year companies typically have until March 15th of the year following the year of vesting to deliver actual tokens to the wallet of an RTU holder.

Subject to compliance with Section 409A, RTUs may also be structured as deferred compensation, providing recipients with often-desired flexibility to defer income tax recognition well beyond the vesting date. Section 409A's rules are complex and contain traps for the unwary. Companies must therefore pay close attention to Section 409A's rules when structuring RTUs. (26 U.S.C. § 409A). For more information on Section 409A, see Section 409A Toolkit. For a general overview of Section 409A, see Practice Note, Section 409A: Deferred Compensation Tax Rules: Overview.

Can companies grant token options?

It is possible to grant options to purchase tokens. However, they are tricky to administer and certain practical realities make them undesirable. They are therefore uncommon.

Traditional stock options are designed to allow service providers to purchase shares of the company's stock in the future at an exercise price set based on the fair market value of the stock at the time of grant. If the value of the stock increases, this provides a benefit to the option holder who, once the option vests, can:

- Buy the shares at a below-market price.
- Receive the spread value, that is, the excess of the fair market value at the time of exercise over the exercise price, as compensation.

Traditional stock options are generally exempt from the application of Section 409A because the underlying shares meet the Section 409A definition of "service recipient stock," which includes a requirement that the underlying stock is treated as common stock under the Internal Revenue Code.

Although there is no current guidance on the topic, tokens are unlikely to qualify as service recipient stock for purposes of Section 409A. This means that an option to purchase tokens would need to be structured to comply with Section 409A. Options that are subject to Section 409A can only be exercised on the occurrence of a narrow set of permissible events, such as the option holder's separation from service, or a fixed date set in advance. Because the defining and most appealing characteristic of an option is the flexibility to exercise the option at a time of the option holder's choosing after vesting, therefore controlling the timing of income recognition, it is generally undesirable to subject an option, whether a traditional stock option or a token option, to Section 409A.

Do token incentive plans replace traditional equity incentive plans?

Often companies that maintain a token incentive plan also maintain a traditional equity incentive plan. However, some employers in the Web3 space maintain only a token incentive plan.

Whether or not a company needs both a token plan and an equity incentive plan depends on the company's underlying business model and goals. Companies focused solely on creating an independent and autonomous token network may issue only token awards, while companies that intend to maintain a development company following the network launch may issue both tokens and traditional equity incentives. In practice, many Web3 companies start out with a traditional equity incentive plan and move to token awards later in their development, as they approach the launch of a token network. In this case, both traditional equity and token-based awards can be issued to employees and other service providers. Some companies allocate their token-based awards following a token generation event (TGE) or token launch (where tokens are available to the public) to be consistent with the allocation of their existing equity-based awards. For Web3 companies building a token network, much of the future value may lie in the network and the tokens themselves. For some entities, once the token network is launched, the employer development company will fade away and the future value will live exclusively in the token network. Accordingly, service providers at these projects expect token-based awards in the protocol (rather than equity awards in the dissolving development company).

How do employers administer token compensation plans and track token awards? Are there third-party administrators?

Companies typically administer token compensation plans in-house. However, as the prevalence of token incentive plans continues to grow, a number of third-party administrators, such as Carta and E*Trade, are beginning to offer products designed to administer token award programs. Organization and diligence are vital aspects of a successful token compensation program, as flaws in administration can lead to errors in the vesting or smart contracts used to administer tokens to service providers. Token issuers must also carefully track the value of their grants to ensure compliance with the value limits of Rule 701. For more information on Rule 701, see Practice Note, Employee Incentive Compensation and the Role of Rule 701.

What happens if a token award does not vest? How does the token issuer recover the tokens?

Cryptocurrency is attractive because of the anonymity and the ease with which it may be transferred. But those same qualities pose challenges for issuers trying to recover tokens after they have been issued. Parties may consider several alternatives to facilitate the recovery of previously issued tokens. For example, token-based awards may:

- Include transfer restrictions within the terms of the token award agreement, similar to the restrictions commonly included in restricted stock award agreements.
- Be protected by smart contracts that automatically restrict their transfer until certain predetermined conditions are met (for example, vesting requirements).
- Programmatically restrict the transfer of the tokens and build vesting restrictions into the token code itself, which is perhaps the strongest form of protection an issuer can adopt to prevent the holder from transferring the token before vesting.

Tax Considerations

The Internal Revenue Service (IRS) has issued guidance and provided examples of how longstanding tax principles apply to transactions using virtual currency. See IRS Notice 2014-21; IRS Revenue Ruling 2019-24; and Frequently Asked Questions on Virtual Currency Transactions.

How are token awards taxed?

Tokens are treated as property for purposes of Code Section 83 (26 U.S.C. § 83) and generally taxed as ordinary income at the time the property is transferred. The transfer of property occurs when a token is issued to a participant's digital wallet following grant or vesting. For an overview of Code Section 83, see Practice Note, Section 83: Property Transferred in Connection with the Performance of Services.

When are token awards taxed?

The timing of taxation depends on the form of token-based award and, in the case of restricted tokens, whether the recipient files an 83(b) election with the IRS.

Token awards

Token awards, which are outright grants of tokens that are not otherwise subject to vesting and forfeiture conditions, are taxed and reported as ordinary income, based on the value of the tokens at the time of grant.

Restricted tokens

For restricted tokens, the taxable event occurs when the tokens vest, unless the recipient files an 83(b) election within 30 days of the grant date. Like restricted stock awards, filing an 83(b) election on a restricted token award allows the recipient to recognize tax on the value of the award at the time of grant. However, if the recipient does not timely file an 83(b) election, the recipient will recognize ordinary income tax on the value of the tokens as they vest and the forfeiture conditions lapse.

RTUs

In the case of RTUs, the value of the tokens are not taxable until the tokens are delivered to a participant's digital wallet, typically, in the case of calendar-year companies, some time before March 15th of the year following vesting.

What are the company's withholding obligations on token-based awards?

Companies that issue token-based awards must comply with income and payroll tax withholding obligations. Withheld amounts must be remitted to the taxing authorities in cash. To satisfy its tax withholding obligations, the company may require participants to remit cash to the company, which it will then send to the taxing authorities. The company may either:

- Withhold from the cash amounts otherwise due to participants.
- Reduce the number of tokens otherwise issuable to the participant by a number of tokens having a fair market value equal to the aggregate tax withholding obligations.

If tokens are withheld, the company must then come up with the cash to send to the taxing authorities.

How are tokens valued for tax purposes?

Typically, the value of a token for tax purposes is determined based on an independent third-party valuation, similar to the valuations obtained for Section 409A purposes. However, unlike the Section 409A valuations obtained by companies for purposes of granting stock options, for example, which may be relied on for up to 12 months, the valuations for tokens typically go stale a lot sooner, often within two weeks, due to the volatile nature of token value. Some well-established protocols with extensive public trading volume base their token valuations on the weighted average trading price over a period of time as recorded on established exchanges such as Coinbase, Crypto.com, or Kraken, to name a few.

Securities Law Considerations

Are tokens securities?

The term "security" is broad and includes an investment contract, as well as other instruments such as stocks, bonds, and transferable shares. In September 2022, SEC chairman, Gary Gensler, stated that "[o]f the nearly 10,000 tokens in the crypto market, I believe the vast majority are securities." Accordingly, "[o]ffers and sales of these thousands of crypto security tokens are covered under the securities laws."

For more information on the SEC's regulation of digital assets, including how the SEC applies the *Howey* test to offers and sales of digital assets, see Practice Note, SEC Regulation of Digital Assets.

Employers should consult legal counsel on securities law implications prior to offering tokens to employees.

What securities law considerations apply to token-based awards?

While there remains some uncertainty regarding which tokens may be securities, indications from the SEC suggest it is prudent for employers to structure token incentive programs that comply with the federal and state securities laws, which require all offers and sales of securities, including those involving digital assets, to either:

- Be registered in accordance with applicable law.
- Qualify for an exemption from registration.

The registration process is arduous and requires disclosure of detailed information to investors, including employees and other service providers who are granted securities as compensation. Therefore, employers granting either traditional equity-based awards or token-based awards generally rely on an exemption from registration. The most common exemption for token awards offered under a written token incentive plan is Rule 701, which provides a safe harbor from registration under the Securities Act of 1933, as amended (Securities Act) for grants of equity securities by a non-reporting company to its employees and certain other persons under the terms of a written compensatory benefit plan or compensation contract. For more information on Rule 701, see Practice Note, Employee Incentive Compensation and the Role of Rule 701.

Are token awards subject to other transfer restrictions?

Yes, for US securities law purposes, token awards are generally subject to a one-year lock-up restriction, during which they cannot be traded or transferred. Even though it is unclear under current guidance whether tokens may be securities, in an abundance of caution, token plans are typically designed to comply with US securities laws as a mitigating and conservative measure. Accordingly, token awards include a one-year holding period applicable to restricted securities under Rule 144 of the Securities Act.

When does the lock-up period begin?

The lock-up period depends on the form of token award. For restricted tokens, the lock-up period begins on the grant date. For RTUs, the lock-up clock may begin to run when the award is granted, provided the tokens have been minted and exist as of that date. However, if the tokens have not yet been minted, the lock-up period will not begin until the TGE occurs. As taxes for RTUs are delayed until the vesting conditions are met and the underlying tokens are delivered to a participant's digital wallet, RTUs typically do not vest until at least one year following the grant date and TGE. This vesting schedule is intended to align the issuance of the tokens with the expiration of the lock-up period, at which point the tokens are tradable when received and can be sold (provided additional transfer restrictions are not present) to help defray the tax burden.

Can companies issue token-based awards outside of the United States?

US-based token incentive plans contemplate grants to US service providers and taxpayers in compliance with

US tax and securities laws. Grants outside of the US are typically made outside of the token incentive plan and require a separate exemption from registration, typically Rule 903 of Regulation S under the Securities Act. As with all grants, companies should consult local counsel to determine if there are any tax, securities laws, or other legal or accounting considerations for issuing token awards outside of the US.

Additional Cryptocurrency Compensation Issues

Can employers pay base salary in cryptocurrency?

Currently, virtual currency is not a permissible form of payment under applicable US employment law. In general, US federal law and, in particular, the FLSA provides that wages must be paid "in cash or negotiable instrument payable at par" (29 C.F.R. § 531.27). Also, while state laws vary, many, if not most, include a requirement that wages be paid in US currency. California, for example, requires that wages be paid in cash or negotiable form of US currency. Cal. Lab. Code §212 (prohibiting payment in "scrip, coupon, cards, or other thing redeemable, in merchandise or purporting to be payable or redeemable otherwise than in money").

While it may be possible to satisfy minimum wage and overtime obligations in cash, and use digital currency for other amounts, most employers are deterred by the administrative burden this creates.

Any employer considering paying wages in the form of cryptocurrency should consult accounting and legal teams before doing so.

Can employers include cryptocurrency in their 401(k) plans?

The availability of cryptocurrencies in 401(k) plan offerings has become a topic of intense debate. On March 10, 2022, the Department of Labor's EBSA published a release cautioning defined contribution plan fiduciaries to "exercise extreme care" before adding cryptocurrencies (including digital assets such as tokens, coins, crypto assets and any derivatives thereof) into the menu of investment options for their participants.

The Department of Labor expressed "serious concerns about the prudence of a fiduciary's decision to expose a 401(k) plan's participants to direct investments in cryptocurrencies, or other products whose value is tied to cryptocurrencies," noting the risks cryptocurrencies pose to retirement accounts, "including significant risks of fraud, theft, and loss," due to concerns surrounding:

- The speculative nature of cryptocurrency investments.
- Valuation difficulty.
- Price volatility.
- Ensuring participants having sufficient knowledge about cryptocurrencies to make informed decisions.
- The evolving regulatory landscape.

Cryptocurrencies also present custodial and recordkeeping challenges as they are entirely digital in nature, and therefore are not held like traditional plan assets in a plan's trust or custodial account.

Given these concerns, the Department of Labor announced that it expects to conduct an investigative program targeting plans that offer cryptocurrencies and related products as investment options, including through a brokerage window, and take any appropriate actions to protect the interests of the plan participants and their beneficiaries.

For now, plan fiduciaries who offer cryptocurrencies as investment options should expect to be heavily scrutinized by the Department of Labor on how they have met their duties of loyalty and prudence to participants. For more on cryptocurrency and retirement plans, see Article, Expert Q&A on Cryptocurrency and Retirement Plans.