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Cryptocurrency Compensation: A Primer on Token-Based Awards



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In the past year, blockchain tokens (more commonly referred to as ''virtual tokens'' or just ''tokens'') have nudged their way into mainstream consciousness with the proliferation of ''initial coin offerings,'' or ''ICOs,'' and the blockbuster rises – and drops – in the prices of cryptocurrencies. An emerging trend sees companies and virtual organizations leveraging the value of these tokens, not only for non-dilutive capital raising purposes, but also to compensate and incentivize founders, directors, employees, consultants and other service providers. Just as with issuances of founder's stock, stock options and other traditional equity-based compensation, token-based compensation requires significant consideration from both a securities law and a tax law perspective.

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The U.S. Securities and Exchange Commission (the ''SEC'') initially provided guidance in July 2017 directing practitioners to apply the test articulated in *SEC v. W.J. Howey Co.* when determining whether an issuer's tokens would be considered securities under the Securities Act of 1933, as amended (the ''Securities Act''), the cornerstone of U.S. regulatory regime with respect to securities. Recent actions brought by the SEC, as well as speeches by its chairman and members of the recently formed cyber unit of its enforcement division, however, have suggested that from the SEC's perspective, all ICOs conducted to date, even offerings of so-called ''utility tokens,'' have borne significant hallmarks of securities offerings. While on a case-by-case basis issuers and practitioners nevertheless may wish to evaluate a given token and token offering using the *Howey* test, for the purposes of this article we assume that tokens being used as the basis for service provider compensation would be viewed as securities by the SEC and so should be issued in accordance with the Securities Act and applicable state securities laws.

The Internal Revenue Service (the ''IRS'') has also issued guidance regarding taxation of ''convertible virtual currencies'' that we believe is also likely to apply to

token-based compensation to service providers. Based on this guidance, under the Internal Revenue Code of 1986, as amended (the ''Code''), tokens issued to individuals in exchange for services would generally be treated as compensation and, as with most compensation, the issuance would generally be subject to income and payroll taxes. As the cryptocurrency market increasingly demands rationalized founder and developer token ownership structures, including appropriate vesting and lock-ups, and as ICOs and other token generation events (collectively referred to as ''TGEs'') are increasingly being deferred until after production of a minimum viable product, more sophisticated token-based award structures have been developed.

By and large, these token-based awards emulate traditional equity-based awards, including restricted tokens, token options and restricted token units. This is not a coincidence: compensatory award structures are largely tax driven, and the Code provisions applicable to token-based awards are the same as those applicable to traditional equity-based awards. Interestingly, we believe that whereas (i) restricted stock awards have predominantly been awarded at companies' early stages, (ii) restricted stock units have been more widely used by companies whose stock is publicly traded and more mature private companies and (iii) stock options are heavily used by companies at all stages, in each case, the opposite should be true with the analogous token-based awards.

Choosing a Token-Based Award

Tokens and Restricted Tokens

A token award would allow the recipient to acquire tokens immediately. With a token award, either the recipient pays for newly issued, outstanding tokens, or the recipient is awarded the tokens as compensation for past or future services, without the recipient paying any cash purchase price. If the tokens are restricted tokens, they would also be subject to vesting based on continued service or achievement of performance targets and can be subject to accelerated vesting upon predetermined triggers, such as the occurrence of a change of control transaction, the termination of an employee without cause, or achievement of technical milestones for the token platform. If the recipient ceases to provide services to the issuer (e.g., if the recipient is an employee and quits), the issuer would have the right, but not the obligation, to repurchase any remaining restricted tokens that have not yet vested, typically at the original purchase paid by the recipient (if any).

Similar to stock awards, token awards will likely be treated by the IRS as property received in connection with the performance of services. With respect to token awards issued without vesting restrictions, the recipient will be taxed in the year the award is made if and to the extent the fair market value of the tokens at the time of the award exceeds the amount paid by the recipient for the tokens (this difference being deemed ordinary income to the recipient that is also subject to payroll taxes). If the tokens are restricted tokens, however, the recipient will be taxed on the difference between the fair market value of the tokens at the time of vesting and the amount paid by the recipient for the tokens (i.e., the ''spread''), unless the recipient files an election with the IRS under Section 83(b) of the Code (commonly referred to as an ''83(b) Election'') within 30 days of receiving the restricted tokens. So, for example, if a portion of the restricted tokens vests each month, and the recipient does not timely file the 83(b) Election, then the tax obligation will be incurred each month in respect of the tranche that vested (and the recipient would likely want to sell all or a portion of her vested tokens on the secondary market to receive the cash needed to pay the tax on this spread).

It is important that a recipient of restricted tokens carefully considers whether filing an 83(b) Election makes sense in consideration of applicable circumstances. If a recipient makes a timely 83(b) Election, in the year of grant, the recipient will be taxed on any difference between the fair market value of the award on the date of grant and the amount actually paid for the restricted tokens, if any, but will defer taxation on all gains in value post-grant until the tokens are actually sold to a third party or otherwise disposed of in a taxable transaction, and will convert all such post-grant appreciation to capital gains. The risk, however, in making an 83(b) Election is that the recipient must pay tax based on the ''spread'' of all awarded tokens at the time of grant, but if the tokens ultimately decrease in value as they vest compared to their value on the date of grant, or if all or a portion of the tokens are forfeited back to the issuer because the recipient's service terminates prior to full vesting, the pre-paid tax on value in excess of actual economic gain from the tokens will not be recoverable.

Each recipient of a restricted token award will therefore need to weigh the potential advantages of starting the clock for capital gains treatment on post-grant gains against the risks that the tokens may lose value or be forfeited. Indeed, while the principles of the 83(b) Election are the same as between restricted tokens and restricted stock, the difference in fact patterns around their issuance complicates that decision calculus. The ''founder's stock'' issued to start-up service providers at the formation of the corporation typically has de minimis value, such that receipt of restricted stock (whether in exchange for a purchase price or as a restricted stock bonus), followed by an immediate 83(b) Election, results in minimal or no tax on the award in the year of grant. Plus, making an 83(b) Election provides protection against incurrence of tax liabilities as stock vests during periods while a start-up is privately held and lacks a secondary market to provide service providers with liquidity alternatives to help pay the tax. In contrast, the value of token awards will be tied to the TGE price (if issued in a TGE) or trading values on the secondary market thereafter, such that a recipient of a restricted token award may have to pay tax on a significant amount of ''spread'' in the year of grant if she wishes to make an 83(b) Election to start her capital gains treatment, and she may have less concern about inability to sell tokens as they vest if a robust trading market exists following the TGE.

Token Options

Similar to a traditional stock option, a token option would provide the recipient the right, but not the obligation, to purchase a pre-determined number of tokens at a pre-set price. The exercisability of the option can be subject to vesting, just as with restricted tokens, and the option would expire some short period of time after the recipient ceases to provide services to the issuer. Token options are likely to be subject to the same tax treatment as nonqualified stock options — no taxation upon

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grant, but upon exercise, the excess of the aggregate fair market value of the exercised tokens over the aggregate exercise price of the exercised tokens (i.e., the ''spread'') would be compensation income subject to ordinary income and payroll taxes.

It is unclear whether token options will be exempt or subject to the rules under Section 409A of the Code. Options are generally exempt from Section 409A if they are granted ''at the money'' and cover ''service recipient stock,'' but there is no definitive guidance to suggest that the IRS would consider tokens awarded to service providers as ''service recipient stock.'' Consequently, issuers should generally assume that token options are subject to Section 409A of the Code and take great care to comply with the requirements of Section 409A. For example, a token option that mimics a plain vanilla stock option whereby the optionee has discretion to exercise vested options over multiple years would not comply with Section 409A and would subject the optionee to significant penalties. Instead, a Section 409A-compliant token option would be exercisable only on certain specified events, such as a specific year or upon an earlier separation from service or change in control. These limitations may make token options less attractive to issuers, relative to traditional stock options.

Although a token option grant does not result in the issuance of a token until exercise, granting the option before the underlying tokens are generated and reserved may be complicated by a number of factors. For example, issuers would need to determine the per token option strike price and fair market value on the grant date, both as a business matter as well as for purposes of exemption from Section 409A of the Code and thresholds for compliance with Rule 701 of the Securities Act, discussed below. Accordingly, token issuers should consider an alternative token compensation structure pre-TGE.

Restricted Token Units

Much like a restricted stock unit (or RSU), a restricted token unit (or RTU) is a promise to pay property to the recipient in the future, usually after time- or performance-based vesting conditions are met. For example, a grant of one RTU would entitle the service provider to payment of one token following vesting. Often, tokens are paid shortly after vesting. However, it is possible to pay the tokens a period of months or years after vesting. Infrequently, vested RTUs are paid in cash (equal to the fair market value of the tokens at the time they would otherwise be paid to the service provider), rather than actual tokens. Payment of a vested RTU, whether in cash or in stock, is often referred to as ''settlement'' of the vested RTU. The vesting feature of RTUs would work similar to that of a restricted token or a token option. While RTUs may be issued prior to the TGE, settlement of vested RTUs into tokens would need to be delayed at least until the issuer's TGE (which could result in ''deferred RTU'' treatment under Section 409A of the Code). Upon termination of continuous service, unvested RTUs would automatically be cancelled. There is typically no tax impact at the time of grant of an RTU. When the underlying units are paid in tokens, the fair market value of the tokens will be treated as income received by the service provider, subject to ordinary income and payroll taxes.

Given the various mechanical and tax issues involved, we expect to see the market for token compensation moving toward restricted token units, particularly for early stage companies. Issuers can make RTU awards pre-TGE, but defer settlement of RTUs until after the TGE. This may permit recipients to delay taxation on the token until there is liquidity, since income from RTUs would be taxed not at grant or vesting, but when tokens are ultimately paid to the service provider. For issuers who do not delay settlement until the TGE, we expect to see hybrid settlement terms, where the RTU settles in tokens if the settlement date is at or after the TGE or settles in cash if the recipient's service with the issuer terminates prior to the TGE. As noted above, if the RTUs are settled in tokens, the recipient will be taxed based on the fair market value of the tokens at the time of settlement, which could be determinable based on the prevailing trading prices for the tokens on prominent exchanges. If cash is received as settlement of RTUs instead of tokens, then the amount of the income recognized will simply be the amount of cash received.

RTUs have other advantages over token options as well, including that fewer RTUs would be needed to have the same compensatory impact to the recipient as a token option, leaving more tokens available for issuance to other service providers. A token option ceases to have value once the fair market value of the underlying token becomes less than the corresponding exercise price. For example, a token option covering one token with an exercise price of $10 loses its value once the secondary market for the underlying tokens falls below $10. However, an RTU will have some value as long the issuer's tokens are worth anything. Even an ''in the money'' token option is worth less than an equivalent RTU: if a single token option has an exercise price of $10, and the issuer's tokens are trading at $12 per share, the token option is effectively only worth $2, whereas a single RTU would be worth the full $12. Because RTUs deliver this ''full value,'' service providers should be satisfied with fewer RTUs. Note that an RSU with one underlying share is typically perceived as tantamount to an option to buy three to five shares of stock; it remains to be seen whether the market will ascribe the same ratio to analogous token-based awards.

Regardless of what form of token-based award issuers choose to use, they should be mindful that token-based awards to employees will be subject to federal and state income tax withholding (at supplemental withholding rates) and payroll taxes. Employers that fail to withhold such taxes are secondarily liable to the tax regulators for such taxes, and under certain circumstances could face an additional penalty equal to 100% of the taxes that were not withheld.

Limitations on Issuances of Token-Based Awards

The factors that impact the form of token-based award an issuer chooses to use are largely tax driven (to convert appreciation to capital gains and to defer taxation until a liquidity event) and apply regardless of whether or not the issuer's token is deemed to be a ''security'' under the Securities Act. While we assume for the purposes of this article that the SEC would consider any token issued as compensation to be a security, even if a utility token were not a security, many practitioners believe that an agreement to acquire a utility token in the future itself constitutes an investment contract un-

der Howey and so is a security. Thus, like a SAFT, or Simple Agreement for Future Tokens, a token-based award in any event may be deemed a security, and its issuance should be compliant with the Securities Act, regardless of whether the issuer believes tokens underlying the awards are or will be ''utility tokens.''

The provisions of the Securities Act are drafted very broadly. As a result, they will apply to any type of issuer, including a decentralized virtual organization. The Securities Act requires that no securities be offered or sold for value unless the issuance has been registered or is exempt from registration requirements. Registration is an arduous, drawn out and expensive process, and in any event it is not a practical alternative solely to permit issuance of securities for compensation of service providers. Instead, the common federal exemption traditionally used by start-ups and other companies to issue traditional equity-based compensatory awards (such as restricted stock, stock options and RSUs), and now used by companies and virtual organizations to issue token based compensatory awards, is Rule 701.

Covered Service Providers

Rule 701 imposes various limitations on, and conditions for, the issuance of securities without registration. First, token-based awards granted under Rule 701 may only be made to the employees, directors, officers, consultants or advisors of the issuer (or certain of the issuer's affiliates).

At first glance, this would seem to mean almost any service provider could qualify to receive token-based awards under Rule 701 by serving as a consultant or advisor to the issuer on a project, including, for example, service as a third-party developer, TGE bookrunner, public relations provider, etc. However, there are special requirements as to the availability of Rule 701 for awards to consultants and advisors.

First, only natural persons are eligible for the exemption, though a consultant operating through a wholly owned LLC, personal corporation or other corporate entity may in some cases be granted token-based awards in reliance on Rule 701. Second, the consultant or advisor must be providing bona fide services to the issuer or its affiliates. Third, the services rendered cannot be in connection with a capital raising transaction, such as an ICO or SAFT sale. This last condition means that token-based awards cannot be issued in reliance on Rule 701 to a consultant or advisor in exchange for finding investors for the issuer or advertising, promoting or facilitating the sale of its tokens in any way.

While Rule 701 may not be available for issuing token-based awards to some consultants or advisors, other exemptions from registration under the Securities Act may be available, including, for example, Regulation D, if the consultant or advisor is an ''accredited investor,'' or Regulation S, if the consultant or advisor is not a U.S. person, and the transaction meets the other requirements of the applicable exemption. Note, however, that there are a host of securities law restrictions that make compensatory arrangements in connection with fundraising efforts dangerous for issuers, especially where success fees are involved.

Written Plan or Agreement

Issuers may rely on Rule 701 to issue token-based awards only where the awards are granted under a written plan or agreement. Depending on the jurisdictions of the issuer and the award recipient, and how those jurisdictions interpret electronic contracts, a ''smart contract'' governing the terms of an award of security tokens may not satisfy the requirement for a written plan or agreement, even if its source code is publicly available to the award recipient. Until smart contracts are more widely recognized by regulators and courts as legally binding obligations, we recommend that issuers adopt a written token incentive plan with the same specificity as traditional equity incentive plans. Companies issuing token-based awards should also document each award using individual award agreements with each recipient and must provide to the award recipient a copy both of the written plan and the individual award agreement.

While issuers may be tempted to draft token incentive plans by simply replacing ''stock'' with ''token'' in precedential equity incentive plans, care should be taken in drafting a token incentive plan — for example, provisions related to lock-ups, changes in control, recapitalizations and post-settlement transfer restrictions either do not apply or have to be significantly altered for application in the context of tokens.

Volume Limitations

Rule 701 imposes limitations on the maximum number of token-based awards that can be granted in reliance on its exemptions. This maximum is determined using a technical and complex formula. To summarize, the aggregate sales price or fair value of the token-based awards made in reliance on Rule 701 during any consecutive 12-month period generally cannot exceed the greater of $1,000,000 or 15% of the issuer's assets as of its most recent balance sheet date. However, if that token-based award value-based threshold has been met, an issuer may still issue token-based awards during the applicable consecutive 12-month period until the total number of tokens underlying token-based awards made in such period reaches 15% of the total number of tokens outstanding as of the issuer's most recent balance sheet date.

Since many issuers are making token-based awards prior to the TGE, such that zero tokens will have been outstanding as of the last balance sheet date, the determination as to the maximum tokens they may issue under Rule 701 will largely depend on the dollar value of their token-based awards. The question then becomes how to determine that value. To analogize to traditional equity-based awards, if the awardee has to pay a certain amount of money, Ether or other currency (whether virtual or fiat) to obtain the token (whether upon ''exercise'' or at the time the award is granted), the amount so paid or payable will likely be the deemed sale price of that award for purposes of Rule 701. Ironically, this means the Rule 701 value will be easier to determine for restricted tokens and token options, where, for the reasons discussed above, a trading market for the underlying tokens should already exist that supports calculation of the value, as compared to RTUs, where the issuer will need to estimate the fair value at the time of grant.

Note that if the amount to be paid by the recipient is denominated in Ether, Bitcoin or some other cryptocurrency, a further complication arises in converting that amount into dollars for purposes of testing the relevant Rule 701 thresholds. (Recipients should also note that current IRS guidance indicates that using cryptocurrencies to pay for an award will also cause that cryptocurrency to be taxed.) Regardless of the method used to

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achieve the conversion, that method should be applied consistently to all awards over time.

Given these volume limitations, to preserve the ability to use Rule 701 for future awards, issuers should consider making awards to certain service providers in reliance on such other exemptions from the registration requirements of the Securities Act where possible, including, for example, Regulation D, which also covers issuances to directors and executive officers.

Disclosure Requirements

If a company grants token-based awards with aggregate purchase price or fair value (determined as discussed above) exceeding $5,000,000 in any 12-month period, additional disclosure must be provided to the person to whom the award is issued. This additional disclosure would include a discussion of the risk factors associated with an investment in the issuer's securities as well as financial statements prepared in accordance with GAAP that may be no older than 180 days. For token options, this disclosure, if required, must be provided a reasonable time before the option is exercised. In the case of restricted tokens, RTUs and other token-based awards, however, the disclosure would need to be made prior to the token based award being granted.

Token issuers that would find it impracticable or otherwise problematic to prepare and provide this level of disclosure should take care to monitor their token-based award programs to ensure that neither the original issuance of their token-based awards nor the issuance of tokens upon exercise or settlement of token options, RTUs or other derivative token-based awards would cause the $5 million threshold to be exceeded.

State Law Requirements

The offering and sale of token-based awards must also comply with the state securities laws (commonly referred to as ''blue sky'' laws) of the jurisdiction of the issuer and its award recipients. Luckily, a number of states include an exemption for securities issuances based on compliance with Rule 701, though some, such as California, may impose additional requirements for exemption of the applicable awards from registration or qualification. As such, it is even more important for issuers to be mindful of the terms and conditions of Rule 701 when granting token-based awards and to conduct a full ''blue sky'' analysis based on the residence of token recipients.

Are Tokens the New Equity?

Ultimately, the same securities, tax and other rules that apply to compensatory equity awards tend to apply to compensatory tokens as well. Whereas the market for compensatory equity is well understood, compensatory token-based awards raise new questions for issuers to answer: Should the issuer offer both equity and token incentive awards? What percentage of tokens to be generated should be reserved for awards to service providers? Should token-based awards be allocated among service providers in the same proportions as traditional equity-based awards?

In any event, we do know that tokens may present solutions to some problems with traditional equity-based awards. For example, token-based awards can be automated using smart contracts, which could decrease administrative costs and errors that are sometimes incidental to equity-based awards. In addition, they more directly incentivize employees to develop the company's product portfolio so as to expand the application and value of the awarded tokens. And of course, token-based awards can be a non dilutive form of executive compensation.