Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 19
Using Tokens to Compensate Employees: What You Need to Know

By Darren Goodman, Eric Weiner, Taryn E. Cannataro,

DECEMBER 2022

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Taryn Cannataro: Welcome to the latest edition of Just Compensation. I'm Taryn Cannataro, an associate in the Executive Compensation and Employee Benefits Group, and I'll turn it over to my colleagues to introduce themselves.

Darren Goodman: I'm Darren Goodman, a partner in the firm's Executive Compensation and Employee Benefits Group.

Eric Weiner: And I'm Eric Weiner, a partner in the tech group and co-chair of Lowenstein Crypto.

Taryn Cannataro: Today's discussion will be related to a hot topic and emerging trend in executive compensation: cryptocurrency and token issuances. In the past year, we've seen a reemergence of crypto companies launching tokens and granting tokens to their employees. In today's podcast, we will provide a brief overview of the various forms of token issuances, how tokens differ from equity, and considerations to keep in mind if you plan to grant tokens to employees. Let's start from the beginning. For those of us who may not know, what is cryptocurrency?

Eric Weiner: Cryptocurrency is a type of virtual currency that utilizes encrypted information to digitally record transactions on a distributed ledger, such as a blockchain. Independent digital systems record the details of transactions in multiple places at the same time with no central data store. Units of cryptocurrency are generally referred to as coins or tokens. While not all companies in the blockchain crypto Web3 space will issue tokens; many have plans to do so. For some of those companies, they believe the real economic value to founders, investors, and employees of the company will actually lie in the token rather than the company's equity. As a result, businesses in this space are beginning to compensate their employees and other service providers via the issuance of token rights in lieu of or in combination with traditional equity incentives.

Taryn Cannataro: How does a company go about issuing tokens to employees?

Darren Goodman: Token issuances are typically granted through a token incentive plan and an individual award agreement, similar to an equity incentive plan, an equity award agreement. In fact, a token incentive plan and an equity incentive plan will often look very similar.

Eric Weiner: I agree, Darren. However, I need to add that it's very important to work with council in drafting a token incentive plan to make sure that it is tailored to the specific facts of the particular company and its token. It's not as simple as simply replacing the word stock with the word token. There are almost always customizations that need to be made in each plan for a particular token issuance.

Taryn Cannataro: What are some considerations a company should be aware of if they want to issue tokens to their employees?

Eric Weiner: Tax considerations are paramount. There is uncertainty about taxations of tokens, but in general, for tax purposes, tokens are treated as a form of property just like stock. We are typically seeing companies issuing restricted tokens. Restricted tokens are analogous to restricted stock. When a restricted token is granted to an employee, the token is transferred to the employee's wallet, subject to vesting requirements. Similar to the issuance of restricted stock, within 30 days of the transfer of the token, the employee can file something called an 83(b) election and elect to recognize ordinary income on the restricted tokens equal to the fair market value at the time of issuance. Restricted tokens are often issued at the time they're created, which means that the tokens usually have very little value at issuance, and the employee therefore has very little tax triggered by the 83(b) election, and after filing the 83(b) election, the employee will not have any tax on the tokens until they are sold.

Taryn Cannataro: I'd also add that to support the valuation of a token when making the 83(b) election, companies can get evaluation from an evaluation firm, similar to what's done for stock options. The one caveat here is that, in our experience, token valuations are only reliable for a short period of time, so it's important to have the token infrastructure in place and all the documentation ready to go in order to issue the tokens as soon as evaluation comes in.

What if a company wants to grant awards before the tokens are ready for issuance? Can they grant token options instead that would not be exercisable until the tokens are ready?

Darren Goodman: Theoretically, options to purchase tokens can be granted, but token options are much trickier than options to purchase common stock. Again, there is some uncertainty, but it appears that a token option granted to an employee that's exercisable after the token is created and whenever the option is vested, like a traditional option, violates section 409A of the Internal Revenue Code. We talked about 409A in detail in a prior podcast, but what's important to know here is that if there's a 409A issued, there are adverse tax consequences to the employees receiving those options, including penalty taxes and interest. Solving that 409A is usually impractical. Could be done, for example, by specifying in advance when the option can be exercised, such as a particular calendar year, but this lack of flexibility is a major downside.

Eric Weiner: I'd add that token options are likely subject to the same tax rules as non-qualified stock options, which means that at the time of exercise, there's ordinary income tax and the difference between the fair market value of the token over the exercise price. If the value of the tokens go up over time, that means the token options would trigger more income tax than restricted tokens with an 83(b).

Taryn Cannataro: Are there other types of token awards that can be issued?

Darren Goodman: A company could grant a restricted token unit, which is analogous to a restricted stock unit. Essentially, if a restricted token unit is granted, no tokens are issued up front. Instead, the tokens would be issued to the employee in the future after vesting conditions are met. There shouldn't be any tax impact at the time of grant. Instead, when the tokens are issued, assuming they're vested at that time, the fair market value of the tokens is ordinary income to the employee. Therefore, they have the same downside as token options, potentially greater tax than restricted tokens with an 83(b) election. Again, though, this is an emerging area, and the right solution can vary based on the company.

Taryn Cannataro: You mentioned earlier that customizations are often required for a token plan. Do you have any examples of a customization that may need to be made?

Eric Weiner: Sure. One example is how to enforce vesting conditions for restricted tokens. When a restricted token is issued, it is transferred to the employee's wallet. The company does not want the employee to be able to sell those tokens before they are vested. Companies navigate this issue by using a multi-signature wallet, where the company and the employee each hold a key to the token so that neither the employee nor the company can transfer tokens without the others' consent. Companies simply won't give consent before vesting.

Taryn Cannataro: Another example is that, unlike in a traditional equity plan, provisions related to lockups, IPOs, changing control, recapitalizations, et cetera, may either not apply or may have to be specifically tailored for application in the context of tokens. So what does the future hold for tokens? Are tokens the new equity?

Eric Weiner: Taryn, I wish I had the answer to that question. I think many people wish they had the answer to that question, but it's really just too soon to make that declaration. As everybody who's sort of following the industry particularly at this time knows, it's been a difficult year, but companies are continuing to use tokens as a way to incentivize their employees, so we would not expect to see token issuance stop anytime soon, especially when the market recovers. In fact, I would expect to see token incentive plans become much more popular over the years to come.

Taryn Cannataro: Token issuances can be a valuable tool for crypto companies to incentivize employees. They present unique considerations, and it's important to consult with counsel to properly document awards and analyze the tax consequences. Despite the downturn in the crypto markets, we expect to continue to see crypto employers granting tokens to their employees.

This episode is intended to give you a high-level overview of various types of token issuances and considerations to keep in mind if you're looking to grant or receive a grant of tokens, but it is by no means a comprehensive discussion of all considerations, and, in addition, individual circumstances can vary. This is a developing area of the law for which guidance continues to change. If you are planning to or thinking about implementing a token issuance or maybe receiving a token grant in the near future, we encourage you to consult with an executive compensation council.

Thank you very much for joining us today. We look forward to having you back for our next episode of Just Compensation.

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