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TOKEN AWARDS

Taxation of Token Awards: What You Should Know

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The tax treatment of tokens as a form of executive compensation is an evolving area of the law. This article discusses how these token awards work and certain tax consequences of them.

Cryptocurrency has been a hot topic for years, and the current volatility and recent performance of various cryptocurrency exchanges have kept cryptocurrency in the news. Despite that volatility, companies in the technology space (especially those in blockchain, cryptocurrency, or web3) still may view cryptocurrency as a valuable tool to compensate and incentivize their employees.

While not all companies in this space will issue tokens to employees, we continue to see many do so. In fact, for some, the real economic value to founders, investors, and employees will lie in the company's tokens, rather than its equity. As a result, companies may choose to compensate their employees via the issuance of token rights in lieu of, or in combination with, traditional equity incentives. In this article, we will discuss how these token awards work and certain tax consequences of them.

What is Cryptocurrency?

Cryptocurrency is a type of virtual currency that utilizes encrypted information to digitally record transactions on a distributed ledger, such as a block chain. 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.” Many companies are creating their own tokens as a way to incentivize employees and are issuing the newly created tokens to their employees.

The rules and regulations regarding the tax treatment of compensatory tokens are not fully developed. The Internal Revenue Service (the “IRS”) addressed the tax treatment of virtual currency in IRS Notice 2014-21 and 2019 Frequently Asked Questions on Virtually Currency Transactions, in which it stated that tokens should be treated as property for federal tax purposes, and general tax principles applicable to property transactions apply to transactions using virtual currency.[1]

Under general tax principles, issuances of property to employees in connection with the performance of services are taxable under Section 83 of the Internal Revenue Code of 1986, as amended (the "Code"). The application of Section 83 to token awards varies based on the type of award, as discussed in further detail below.

Documentation and Administration

Token issuances are typically granted to employees through a "token incentive plan" and an individual award agreement, which are analogous to a typical equity incentive plan and award agreement. Awards that may be issuable under a token incentive plan are also analogous to those issuable under an equity incentive plan, including restricted tokens, unrestricted tokens, restricted token units, and token options. Given that token compensation awards are relatively new, companies are often administering them in house, but certain third-party administrators such as Carta are beginning to offer token administration services.

Unrestricted and Restricted Tokens

Under an unrestricted token grant, an employee acquires tokens immediately upon grant with no vesting requirements. Under Section 83, the employee will recognize ordinary income equal to the fair market value of the tokens at the time of grant, and the employee will not incur additional income tax until the employee transfers the tokens.

When a restricted token is granted to an employee, the employee acquires tokens immediately upon grant by receiving the token in a digital "wallet", but those tokens are subject to vesting requirements, such as time-based vesting restrictions. To prevent the employee from transferring the tokens from their digital wallet before they are vested, the tokens could be secured through smart contracts that restrict transfer until the vesting conditions have been satisfied.

The tax consequences of restricted token awards are analogous to those of restricted stock awards. Employees who receive restricted tokens may elect to file a Section 83(b) election (an "83(b) election") within 30 days of grant, to be taxed on the tokens at ordinary income rates based on the fair market value of the tokens at the time of grant. If an 83(b) election is filed, there will be no ordinary income tax due when the restrictions on the restricted tokens lapse, and the employee will not incur additional income tax until the employee transfers the tokens. If the employee does not file an 83(b) election, the restricted tokens will be taxed at ordinary income rates at the time the tokens vest, based on the fair market value at the time of vesting.

Restricted token awards are particularly attractive when the tokens being issued have little or no value. By filing an 83(b) election, the employees can minimize the amount of ordinary income tax, and have the potential for long-term capital gain treatment for all future appreciation. If the restricted tokens decrease in value or are forfeited, the restricted token holders cannot receive a refund for the tax paid at the time the 83(b) election is filed; however, if the amount of ordinary income tax incurred as a result of the 83(b) election was minimal, the inability to receive a refund may be immaterial.

Restricted Token Units

Similar to restricted stock units ("RSUs"), restricted token units ("RTUs") are a contractual promise to provide tokens to the employee's digital wallet in the future, usually after meeting certain time-based or performance-based vesting conditions. RTUs, like RSUs, are normally "full value" awards, which means that there is no purchase price, so the RTUs share in the full value of the underlying tokens.

The tax consequences of RTUs are similar to RSUs. There is no income tax due at the time the RTU is granted or vests; the employee recognizes ordinary income equal to the fair market value of the tokens when they are transferred to the employee's digital wallet in settlement of the vested RTUs. RTUs may be particularly attractive for companies whose tokens have material value, and therefore 83(b) elections would be unappealing to employees.

RTUs must be structured to either be compliant with or exempt from Section 409A of the Code ("Section 409A"). RTUs should be exempt from Section 409A if the underlying tokens must be issued by no later than March 15 of the year following the year in which vesting occurs (additional time may be available for companies that do not have calendar year fiscal years). Alternatively, RTUs may be compliant with Section 409A if the underlying tokens can only settle on a permissible payment event, discussed further in "Token Options," below.

Token Options

Similar to stock options, token options provide the employee the right, but not the obligation, to purchase a pre-determined number of tokens at a set exercise price. Similar to traditional stock options, token options may be typically structured to have time-based and/or performance-based vesting conditions. In addition, like non-qualified stock options, token options should be taxable at the time of exercise, based on the difference between the fair market value at the time of exercise, and the exercise price.

However, token options may be less appealing than stock options for one key reason. Options to purchase "service recipient stock" are normally designed to be exempt from the requirements of Section 409A. However, it appears unlikely that tokens constitute "service recipient stock" for purposes of Section 409A. Therefore, to avoid adverse tax consequences under Section 409A, token options would generally need to be "409A compliant," meaning that the token options could only be exercisable upon a pre-determined "permissible payment event" (or the earliest of, or latest of, more than one permissible payment event).[2] This lack of flexibility is a significant downside compared to stock options, which are normally exercisable at any time after vesting.

Tax Withholding

As with equity incentive awards, companies must ensure that they comply with tax withholding and reporting requirements. The general principle for token awards is the same as for equity incentive awards – when an employee has ordinary income (such as when an 83(b) election is filed), the company has a corresponding withholding and reporting obligation. Tax withholding must be remitted in cash; companies can either require employees to satisfy that cash withholding obligation as a condition of issuance of the tokens, or reduce the number of tokens issued and remit cash on the employees' behalf.

Token Valuation Issues

One of the challenges with issuing token awards is determining their fair market value. Typically, companies issuing compensatory tokens obtain an independent third-party valuation, analogous to a 409A valuation for stock option purposes. However, while companies can generally rely on stock option valuations for up to one year (unless a material event occurs in the interim), token valuations are reliable for a much shorter period of time (such as two weeks). That means, for example, that if a company plans to issue restricted token awards for which employees will file 83(b) elections, the company should plan ahead to ensure that it has a reliable valuation at the time the awards are granted.

Conclusion

Token issuances can be a valuable tool for companies to incentivize employees, especially for those companies in the blockchain, cryptocurrency, or web3 space. The tax treatment of tokens as a form of executive compensation is still an evolving area of the law. While compensatory equity is well-understood, token awards present unique considerations and there is little IRS guidance available. Despite these unknowns and the recent downturn in the crypto markets, we continue to see employers granting tokens to employees as a form of incentive compensation to their employees.

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1 The IRS has also issued Notice 2023-27 on 3/21/2023, requesting public comment about the proper definition of nonfungible tokens (“NFTs”), including, among other things, factors to consider when determining whether an NFT is a “collectible” for purposes of Section 408(m) of the Code, and what other guidance relating to NFTs would be helpful.

2 Under Section 409A, those payment events are limited to, in general, (1) a fixed date, (2) a separation from service, (3) a change in control event, (4) disability, (5) death, (6) an unforeseen emergency, and (7) the lapse of a substantial risk of forfeiture.

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