NELSON MULLINS

FinTech University:

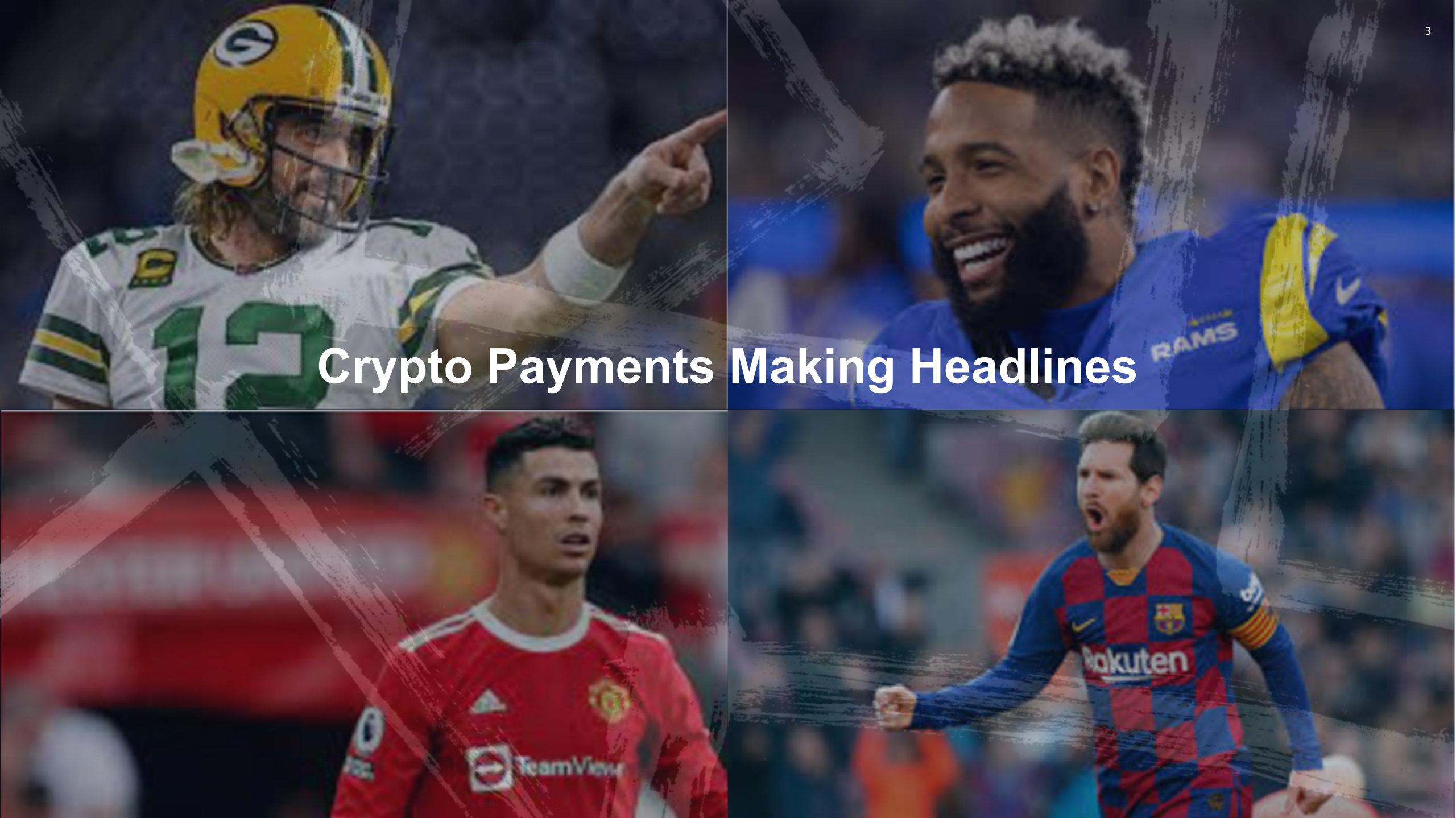
FinTech and Employment Compensation Issues

July 19, 2022

Summary of Presentation

This Presentation summarizes the employment and tax considerations under federal, state, and local laws for compensating employees and independent contractors in cryptocurrency and digital assets.

Please submit any questions that we can answer at the end of the Presentation.



Crypto Payments Making Headlines

Crypto Payments Making Headlines

Crypto Payments Making Headlines

- New York Mayor Eric Adams famously announced that he would accept his first three paychecks in Bitcoin, and the city promoted a conversion system for cryptocurrency compensation.
- A January 2022 press release clarified that, “due to U.S. Department of Labor regulations, New York City cannot pay employees in cryptocurrency.
- By using a cryptocurrency exchange, anyone paid in U.S. dollars can have funds converted into cryptocurrency before funds are deposited into their account.”

Why the demand?

- **Recruiting/retention:** Competition for talent in a market where employees expect/demand crypto as compensation
- **Industry:** Company is in the FinTech space
- **Image:** Companies want to appear cutting-edge, employees want to work for a forward-thinking company
- **Reward:** Hopes for big gains

Agenda

- Introduction
- Applicable Laws
- Risks
- Payment in Company Tokens and other Digital Assets
- Incentive Pay
- Tax Considerations
- Securities Considerations
- 401(k) and Retirement Plans

Federal Law: FLSA

- **The Short Answer:** The Fair Labor Standards Act (the "FLSA") likely prohibits companies from paying employees' base compensation, *i.e.,* wages, with digital assets.

- Digital assets are not "cash or negotiable instruments" as required under the FLSA.

- **§ 531.27 Payment in cash or its equivalent required**

  (a) Standing alone, sections 6 and 7 of the Act require payments of the prescribed wages, including overtime compensation, ***in cash or negotiable instrument payable at par***.

DOL Guidance

- In a May 2006 Opinion Letter, the DOL interpreted "negotiable instrument payable at par"
  - Authorized payments to employees with foreign currency to satisfy minimum salary requirements for exempt employees
  - Permitted when currency met the FLSA threshold after being exchanged into USD using "exchange rate current at the time of payment (*i.e.,* the rate generally available to an individual person in the vicinity where the employee was working).
- Companies face a significant administrative burden trying to control, justify, and/or sufficiently meet these standards for digital assets
- DOL has not determined whether cryptocurrency constitutes a "negotiable instrument payable at par."

Other Federal Wage Issues: Minimum Wage, Overtime

- **Federal Minimum Wage:** $7.25/hour.
- **FLSA Overtime:** 1.5 times the regular rate of pay for any time over 40 hours.
- **Overtime exemptions**
  - Under federal law, employees must receive a minimum of $684/week, or $35,568 annually if classified as exempt from overtime and minimum wage requirements. (FLSA Section 13.1 / 29 U.S. Code § 213)
  - To qualify for the highly compensated employee exemption, employees must be paid total annual compensation of $107,432 or more.
- Due to dramatic fluctuations in digital asset values, employers risk liability and penalties for wage violations and misclassifications if the value decreases below federal minimums in a given pay period.
- Ensuring compliance imposes additional administrative burdens on employers.

Classification Issues: Overtime

- **Overtime Exemptions**
  - Applies to managerial, operational, and/or specialized positions, but must meet $684 weekly salary threshold.
  - Payment through digital assets complicates employer compliance with the salary basis threshold.
  - This may separately expose employers to misclassification issues.

Classification Issues: Independent Contractors – An Exception?

- Maybe…
  - The FLSA does not regulate how employers pay independent contractors.
  - Theoretically, employers could pay independent contractors in virtual currency or other digital assets.
- But, classification tests are not one sized fits all and present other risks…
  - Workers are not independent contractors unless they meet criteria that varies largely between states, and, at minimum, include operational control over their work and equipment, evidence that the worker runs their own business, and other factors like control over their schedule.

Independent Contractor Issues

- Under broader tests, like the “ABC” test followed under laws like California’s AB5, the analysis becomes more uncertain, and more difficult, for employers to successfully prove a worker is an independent contractor.

- **Other risks**

  - Even if employers properly classify workers as independent contractors, questions created by virtual currency pricing volatility may expose employers to other liabilities like breach of contract for failure to pay and other liabilities.

  - Damages in that context, based on court decisions to date, may be the highest value of the digital asset until a case is decided. (See *Diamond Fortress Technologies, Inc. v. EverID, Inc.* (Del. Sup. Ct. Apr. 14, 2022).

- **Proceeding with caution**

  - Any contract with properly classified independent contractors should be airtight, and focus less on the dollar value of the assets or currency exchanged for services, and instead the quantity. Contracts should separately provide for volatility risk.

Misclassification…Don't Go It Alone

- **RECOMMENDATION**: Seek legal advice for any questions involving independent contractor classification before you enter into the relationship
- This analysis **must** be performed on a case-by-case basis.
- Penalties for Misclassifying employees includes:
  - IRS fines
    - Payment of FICA taxes and income tax withholdings
    - IRS Penalties for Inaccurate W-2 Forms
    - Additional Penalties
  - DOL Audits and Penalties
  - Class Action Lawsuits
  - Wage Claim Audits
  - Worker's Compensation Penalties
  - Employee Benefits Liability

Misclassification…Don't Go It Alone

- Proper classification requires a nuanced analysis of several factors, which vary by state, including:
  - Presence of a written contractor agreement
  - Degree of control over relationship
  - Level of instruction
  - Company training
  - Integration of services into business operations
  - Whether services are required to be performed personally
  - Authority to hire and supervise assistants
  - Length of relationship
  - Set work hours
  - Whether full time services are required
  - Location where services are provided
  - Reporting requirements
  - Rate of pay
  - Payment of business and travel expenses
  - Furnishing tools and materials
  - Right to discharge
  - Worker's right to terminate
  - Investment in trade
  - Realization of profit or loss
  - Ability to work for more than one company at a time
- **CAUTION:** Many states consider additional factors for worker classification

State Wage Laws: Method of Payment

- Many state laws are more rigorous than FLSA requirements. For example…
- **Method of Payment**
  - California – requirement that any non-cash payment must identify where the recipient can redeem the instrument received. (*Cal. Labor Code § 212*)
  - Florida – employers who issue alternative payments are liable for the value of the payment in U.S. currency. (*Fl. Code 2005 Ch. 532.02*)
  - Illinois – "wages and final compensation shall be paid in lawful money of the United States." (*820 ILCS 115/4*)
  - Pennsylvania – "wages shall be paid in lawful money of the United States or check." (*43 P.S. Labor § 260.3*)

State (and local) Wage Laws: Minimum Wage and Overtime

- **Minimum Wage**
- California: $14-15/hour (depending on company size)
  - San Francisco: $16.32/hour
  - Los Angeles: $16.04/hour (starting July 1, 2022)
- New York: $13.20/hour
  - New York City: $15/hour
- Florida: $10/hour

- **Overtime and Exemptions**
- California:
  - Double time over 12 hours/day
  - Salary basis test for exempt employees: $58,240 (depending on employer size)
- **CAUTION**: Many other state and local laws impose more onerous minimum wage and overtime requirements

State (and local) Wage Laws: Independent Contractors

- **ABC Test (California, Illinois, Georgia…)**
  - The worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact;
  - The worker performs work that is outside the usual course of the hiring entity's business; and
  - The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.
- **Common Law Test (New York, Texas, South Carolina…)**
  - Behavioral control: Employer controls how workers perform work.
  - Financial control: employers pay compensation and other expenses.
  - Type of relationship: What do the contracts say? What are the terms of employment.

Pay Period and Pay Stub Laws

- Depending on a worker's location, requirements can be variably onerous for compliance with pay stub, wage notice, or pay period laws – employers must be separately equipped and certain that their payroll teams can handle this.
  - California: detailed payroll requirements; violations subject to PAGA claims
  - Colorado: pay statements must include gross and net wages earned
  - Connecticut: weekly paychecks required unless otherwise approved by the labor commissioner
  - Washington State, New York, Virginia: basis of pay and rate of pay listing required on pay stubs, and any deductions
  - Georgia: Twice a month, no paystub requirements
- Employers using payroll vendors or automated software may be unable to properly meet these requirements based on availability of certain digital assets, including delivery to employee's digital wallets, or other calculations like gross and net wages based on fluctuating value of applicable assets or tokens.

Remote and Hybrid Employees

- Many employees requesting payment in cryptocurrency and digital assets work remotely.
  - As employers consider where employees are performing work, laws will also vary from state to state based on the employee's assigned work location, time spent in a particular state or city, etc.
  - Applicable state law must be considered for all employee compensation issues.
  - Crypto is designed to smooth over cross-border details, but the compensation issue creates new multi-jurisdictional questions.

Other Possibilities - Same Risks

- Conversion
  - Some commentators opine that a way around the wage issues just described is for employers' payroll departments to pay wages in fiat currency, but convert those wages after the fact into digital assets, placing the converted asset in an employee's digital wallet (see the NYC example).
    - Consider the pay stub issues just described. This creates a similar risk for payroll violations.
    - Digital asset, exchange, and other conversion fees may further complicate wage and hour reporting or related tax obligations, among other issues.
  - Several states prohibit wage payments with fees that lower the employee's compensation.
    - Employers may need to bear the expense of transferring funds to cryptocurrency or other digital assets.

What about bonuses?

- Incentive compensation is not regulated by the FLSA
  - Note – State laws may impose additional requirements.
- *Can I pay my employees bonuses in digital currency?*
  - Probably, subject to several important considerations, and DO NOT ignore the risks.

Crypto Bonuses: Risk Factors

- Volatility
  - Employees may rely on expected bonuses and be shocked when a market swing or currency failure leaves them with far less than anticipated
- Taxes
  - Employees who realize an opposite result may suddenly face a tax burden they are not prepared or equipped to handle. How assets are characterized affects this.
  - Employers should also pay close attention to reporting requirements to understand how payment through potentially volatile assets may affect their own obligations.
- Shifting and Variable Regulations
  - Do not forget that wage laws like pay stub requirements, among others, apply in many jurisdictions to bonuses as well. Incentive pay via alternative currencies could affect any number of other topics we've discussed so far.

Crypto Bonuses: Risk Avoidance

- **Exception and Not the Rule**
  - Employers should consider making incentive pay through digital assets available only where employees request the option.
  - Employers should not force employees to accept this kind of bonus, particularly if pre-existing polices affect or create an expectation of additional compensation.
- **Put Risks in Writing…Put Everything in Writing**
  - Employees who request or opt to receive incentive pay, bonuses, or other non-wage compensation through digital assets should sign and acknowledge that they understand the risks inherent to this kind of compensation, including volatility and tax issues like earlier slides discussed.
  - Employers should work with legal advisors to make sure those risks and any related laws or regulations are clear and easy to understand.

Payment in Company Currency: Scrip Laws

- Companies that issue their own tokens or other digital assets/currency may not pay employees in that currency as a substitute for wages.

- Federal and other state laws prohibit payment in company "scrip," or other company issued coupons or credit cards. (*See* 29 CFR § 531.34 **- Payment in scrip of similar medium not authorized**.**).**

- Compensation paid with limited avenues for redemption may be equivalent to the forcing employees to shop at the "company store."

- Employers looking to equate these kinds of payments under an options or incentive gamification model should tread carefully and assess this on a case by case basis.

Payment in Scrip

- Scrip frequently used in mining towns, lumber camps in the early 20th century.
- Companies would pay employees in their own currency (scrip) accepted at company stores and for housing.
- High potential for abuse
  - High prices at company stores
  - Lack of alternatives
  - Early payday lending for advances on payment
  - Difficulty converting to cash
- Federal government banned its use in 1938 through the Fair Labor Standards Act.

Payment in Scrip

- 29 C.F.R. § 531.34 – Payment in scrip or similar medium not authorized.
- *Scrip, tokens, credit cards, "dope checks," coupons, and similar devices are not proper mediums of payment under the Act.*
- They are neither cash nor "other facilities" within the meaning of Section 3(m).
- However, the use of such devices for the purpose of conveniently and accurately measuring wages earned or facilities furnished during a single pay period is not prohibited.
- Piecework earnings, for example, may be calculated by issuing tokens (representing a fixed amount of work performed) to the employee, which are redeemed at the end of the pay period for cash.
- The tokens do not discharge the obligation of the employer to pay wages, but they may enable him to determine the amount of cash which is due to the employee.

Securities Considerations

- Regulators like the SEC have yet to determine that digital assets (including company-issued tokens) are securities.
- If they make that determination, employers must comply with federal and state securities laws when using them as compensation.
- Based on these laws, it is again not advisable, at the very least, to issue any such compensation to non-exempt employees.
- Employers should ensure applicable are timely informed of these updates to avoid breach of contract issues or other headaches relating to those employees' incentive compensation.
- Employers should make similarly clear information resources available relating to evolving capital gains treatment of digital assets, including potentially retroactively effective new laws like updates to wash-sale rules.

Crypto-Currencies

- IRS Notice 2014-21 concludes that convertible virtual currency is treated as property for federal income tax purposes.
- Bitcoin (BTC) was explicitly identified by the Notice and the IRS FAQs as an example of a convertible virtual currency, and, therefore, it is treated as property for federal income tax purposes.
- Other convertible currencies include Ethereum (ETH) and Ripple (XRP).
- Convertible virtual currency is described as a virtual currency that has an equivalent value in real currency or that acts as a substitute for real currency. Not all virtual currencies are treated as being convertible.
- The General Accounting Office explained in a 2014 Report that the term “virtual currency” refers to “a digital representation of value that is not government-issued legal tender.”
- Some virtual currencies can only be used within virtual economies and may not be readily exchanged for government-issued currencies such as U.S. dollars, E.U. euros, or Japanese yen.
- Other virtual currencies may be used to purchase goods and services in the real economy and can be converted into government-issued currencies through virtual currency exchanges and are addressed in Notice 2014-21 and the FAQs.

Federal Income Tax Classification of Virtual Currencies – Currency vs. Commodity?

- Notice 2014-21 explains that real currency is “the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance.”
- The Notice further describes virtual currencies as operating in some environments like real currency.
- The IRS noted that virtual currencies were not legal tender in any jurisdiction at the time the Notice was published, and based upon these attributes, there were no virtual currencies that could have generated foreign currency gain or loss.
- Furthermore, subsequent guidance in the form of updated FAQs issued by the IRS, specifically excluded a virtual currency that is a digital representation of the U.S. dollar or a foreign currency.
- A virtual currency based on the U.S. dollar could theoretically be treated as “money” rather than property for federal income tax purposes.
- The Commodity Futures Trading Commission has determined that Bitcoin is a commodity, and Bitcoin futures contracts trade on the Chicago Mercantile Exchange.
- Moreover, the treatment of Bitcoin as a commodity under the Commodity Exchange Act (the “CEA”), and for federal income tax purposes, would be compatible with its treatment by the Treasury Department under the Bank Secrecy Act (hereinafter the "BSA") and the views expressed by the Chairman of the Securities and Exchange Commission (the “SEC”).
- In general, Bitcoin seems likely, though there can be specific exceptions, to be treated as a commodity for federal income tax purposes.

Federal Income Tax Classification of Virtual Currencies – Character of Income, Gain, or Loss

- As is the case with other property exchanges, a taxpayer who receives virtual currency as payment for goods or services generally must, in computing gross income, include the fair market value of the virtual currency, measured in U.S. dollars, as of the date that the virtual currency was received.
- The basis of virtual currency that a taxpayer receives as payment for goods or services is the fair market value of the virtual currency in U.S. dollars as of the date of receipt.
- Similarly, a taxpayer who exchanges virtual currency for other property or services may have gain or loss on the transaction if the value of the property or services received is different than the basis of the virtual currency in the hands of the purchaser.
- The character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer.
- A taxpayer realizes capital gain or loss on the sale or exchange of virtual currency that is a capital asset in the hands of the taxpayer.
- If Bitcoin is held by a taxpayer for one year or less, the gain or loss on disposition will be treated as short-term capital gain or loss. If the Bitcoin is held for more than one year before selling or exchanging it, the gain or loss will be long-term capital gain or loss.

2021 Form 1040 - Reporting of Virtual Currency Transactions

- On March 18, 2022, the Internal Revenue Service announced that taxpayers are required to answer a “yes or no” virtual currency question at the top of certain forms.
- The question concerns all taxpayers who file Form 1040, Form 1040-SR or Form 1040-NR, not just those who transacted virtual currency in 2021.
- Taxpayers ***who only owned*** virtual currency in 2021 can check “no” if they have not engaged in any transactions involving the currency during the year.
- Taxpayers ***who disposed of any virtual currency that was held as a capital asset through a sale, exchange, or transfer*** must check “yes” and use Form 8949 to figure out their capital gain or loss to report it on Schedule D Capital Gains and Losses.

Jarrett v. U.S.

- Joshua Jarrett reported crypto staking rewards as income and paid taxes.
- Jarrett subsequently filed an amended tax return and demanded a tax refund, arguing that the staking rewards were property that should only be taxed at the time of sale (not receipt).
- IRS granted the refund. Jarrett refused to cash the refund, apparently to obtain legal precedent.
- Department of Justice Tax Division dismissed as moot because the refund was granted.
- Dismissal means there is no precedential value regarding the timing of taxation for crypto staking rewards.
  - The grant of a refund for one year is neither a prospective nor universal statement of IRS policy about the many individual items reported on a tax return for a given year.

Benefit Plans: Bitcoin 401(k)

- In March 2022, the United States Department of Labor (the "DOL") released Compliance Assistance Release No. 2022-01 - 401(k) Plan Investments in Cryptocurrencies - outlining its expectations and concerns behind adding digital assets to the menu for benefits like 401(k) plans.

- The DOL covered risks like volatility, but also noted that plan participants are often less equipped to make informed investment decisions, which places them at a greater risk of subjecting their retirement plans to crypto's less certain price fluctuations and regulatory future.

- Plan administrators may NOT shift responsibility for these decisions to plan participants.

- Any employers that employ plan administrators should ensure that those administrators are prepared to face DOL scrutiny subject to its new directives, the parameters of which may not be clear, or face major penalties.

Benefit Plans: Bitcoin 401(k)

- The Compliance Assistance may provide some guidance on the DOL's future interpretation of payment issues.

- Raises concerns with:

  - The high degree of speculation and extreme price volatility of digital asset investments
  - Plan participants ability to make informed investment decisions relating to digital assets
  - Custodial and recordkeeping issues
  - Valuation

- **CAUTION:** Compliance Assistance focuses on plan fiduciaries (identifying the standard of conduct and care for ERISA administrators as "the highest known to the law").

What's Next

- We expect Congress, state legislatures, the Department of Labor, the IRS, and various state agencies to weigh in on all of these issues.
- It is important to stay informed on all developments.
- Subscribe to FinTech Nostradamus for updates on key developments.
- If you offer payment in cryptocurrency or digital assets, seek counsel on an ongoing basis to evaluate the changing landscape.
- Advise employees in writing of risks inherent to receiving payment in cryptocurrency and digital assets.

Presenter Biographies

CHRISTOPHER EBY

Chris is a Denver-based partner in Nelson Mullins Riley & Scarborough's FinTech and Labor and Employment practices. Chris advises clients throughout the FinTech space on a variety of employment matters with a focus on employment issues for emerging companies, wage and hour compliance, and resolving disputes between founders. Chris also represents employers in litigation matters before federal and state courts, administrative agencies, and at arbitration. Chris regularly speaks and write about developing employment issues, especially those relating to FinTech.

MATT ZISCHKE

Matt has experience advising all types of employers on a variety of benefits matters, including design, implementation, and administration of employee benefit plans such as defined benefit, defined contribution (e.g. 401(k) and 403(b)), equity incentive, deferred compensation, and health and welfare arrangements. Matt's experience includes SIMPLE IRA, ESOP, cafeteria, wrap, HRAs, HSAs, and severance plans.

JOHN VEYSEY

John is a Senior Associate in Nelson Mullins' Boston office where he focuses primarily on business litigation, labor and employment law, FinTech, and compliance issues. John's employment, litigation, and FinTech practice regularly addresses overlapping areas of law, including intellectual property, corporate governance, employee mobility and trade secrets, securities, and other novel subject matter in areas like technology, finance, and healthcare. John frequently writes about and advises clients on rapidly evolving FinTech issues, including their intersection with other legal areas like employment law, and related multi-jurisdictional laws, risks, and obligations.

Moderator Biography

RICHARD B. LEVIN

Richard is chair of the FinTech and Regulation Practice and was one of the first lawyers to focus on the regulation of blockchain and digital assets. He is considered a thought leader in the FinTech space. Richard brings his experience as a senior legal and compliance officer on Wall Street and in London to bear in advising clients on corporate, FinTech, securities, and regulatory issues. A problem-solver by nature, he has been advising FinTech clients on legal and regulatory issues since the start of electronic trading in the late 1990s. His practice focuses on helping financial services and technology clients identify and address regulatory issues as they build their businesses.

Richard's practice focuses on the representation of early stage and publicly traded companies in the FinTech space, including investment banks, broker-dealers, investment advisers, peer-to-peer lending platforms, digital currency trading platforms, alternative trading systems (ATSs), exchanges, and custodians. He represents these firms before the U.S. Securities and Exchange Commission (SEC), the U.S. Commodity Futures Trading Commission (CFTC), the Financial Industry Regulatory Authority (FINRA), the U.S. Department of the Treasury, Office of the Comptroller of the Currency (OCC), state regulators, and Congress. Richard has represented clients before regulators in Australia, Canada, France, Germany, Hong Kong, Ireland, Japan, Singapore, South Korea, and the United Kingdom. His current and past clients include leading national financial institutions, multinational financial services holding companies, leading firms in the FinTech space, and institutions engaging in global investment banking, investment management, securities, and other financial services with institutional clients.

Richard has been identified by Chambers and Partners as one of the leading lawyers in the Blockchain and Cryptocurrencies category since the inception of the category. He has been recognized by Chambers for his knowledge on regulatory matters, great relationships with regulators, for helping clients push the boundaries of the FinTech sector, and for his advice on matters such as broker-dealer licensing and alternative trading systems. Richard is routinely quoted by leading publications including Bloomberg, the New York Times, Reuters, and the Wall Street Journal and is a frequent speaker at conferences around the world on the regulation of FinTech, blockchain, and digital assets.

Contact Details

To learn more about our FinTech and Regulation practice, or to contact a member of our team, click here or visit our website at nelsonmullins.com.

To learn more about this presentation, please call:

Chris Eby
1440 Wewatta Street
Suite 500
Denver, CO 80202
Tel. 303-583-9919
chris.eby@nelsonmullins.com

John Veysey
One Financial Center
Suite 3500
Boston MA, 02111
Tel. 617-217-4645
john.veysey@nelsonmullins.com

Matthew Zischke
201 17th Street, NW
Suite 1700
Atlanta, GA 30363
Tel. 404-322-6312
matt.zischke@nelsonmullins.com

Richard B. Levin
101 Constitution Ave., NW
Suite 900
Washington, D.C. 20001
Tel. 202-689-2845
richard.levin@nelsonmullins.com

About This Publication

- Nelson Mullins provides this material for informational purposes only.
- The material provided herein is general and is not intended to be legal advice.
- Nothing herein should be relied upon or used without consulting a lawyer to consider your specific circumstances, possible changes to applicable laws, rules and regulations and other legal issues.
- Receipt of this material does not establish an attorney-client relationship.
- Nelson Mullins is very proud of the results we obtain for our clients, but you should know that past results do not guarantee future results; that every case is different and must be judged on its own merits; and that the choice of a lawyer is an important decision and should not be based solely upon advertisements.