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When Are Cryptocurrencies Appropriate Investments for Retirement Plans and IRAs? U.S. Labor Department Cautions 401(k) Plan Fiduciaries to Exercise Extreme Care

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Cryptocurrencies and digital assets – such as bitcoin, ether and non-fungible tokens (“NFTs”) – have become some of the hottest investment products in recent years. The growing interest has inevitably led to retirement plan participants and individual retirement account (“IRA”) owners wanting to invest their tax-deferred retirement assets (“plan assets”) in cryptocurrency. Investing plan assets in cryptocurrency is complicated, however, because of the complex rules that federal law imposes on fiduciaries of retirement plans and IRAs.

The U.S. Department of Labor (“DOL”) recently issued guidance for the first time on the investment of retirement plan assets in cryptocurrencies. Compliance Assistance Release No. 2022-01 cautions 401(k) plan fiduciaries to “exercise

extreme care” before allowing participants to invest plan assets in cryptocurrencies because cryptocurrencies “present significant risks and challenges to participants’ retirement accounts, including significant risks of fraud, theft, and loss.” The DOL expects to investigate 401(k) plans that allow participants to invest their plan accounts in cryptocurrencies in order to protect participants and beneficiaries from the risks inherent to investing in cryptocurrencies.

WHAT IS CRYPTOCURRENCY?

Virtual currency (also referred to as “cryptocurrency,” “digital assets,” “tokens” and “digital currency”) is said to have been created in 1998, but it was not until bitcoin’s introduction in 2009 that virtual currency gained international notice. The virtual currency definition varies among regulators and government entities. The Financial Action Tax Force, the Securities Exchange Commission (“SEC”) and the Internal Revenue Service (“IRS”) all define virtual currency as “a digital representation of value that can be digitally traded and functions as (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value.”

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This article uses “cryptocurrency,” “virtual currency” and “digital assets” interchangeably. The IRS and the Commodity Futures Trading Commission (“CFTC”) tend to use the terms “virtual currency” or “digital assets.” The SEC generally uses the terms “digital assets,” “coins” or “tokens,” and the popular press almost always uses the term “cryptocurrency.” Popular cryptocurrencies include bitcoin (“BTC”), ether (“ETH”), and many thousands more, including cryptocurrencies that are not frequently traded.

WHAT ARE NFTS?

NFTs are unique digitized tokens that are recorded and transferred on a blockchain. An NFT can be a representation of something (a work of art, a photograph, a piece of music, a game or a collectible), or it can be an original creation that exists only in digital form. NFTs also include access to events and experiences available only to the NFT holder. NFTs are typically purchased and sold using the type of cryptocurrency or digital token (collectively referred to as tokens) used or accepted on that particular blockchain. Initially, NFTs were almost exclusively created on the Ethereum blockchain and purchased with ETH, which is the native token of that blockchain. But now, NFTs are created on other blockchains, and NFTs can be purchased for US currency, other cryptocurrencies and tokens native on those blockchains.

As a “smart contract,” each NFT has embedded metadata that allows relevant information to be visible and stored on the blockchain in a transparent and immutable way. The metadata verifies ownership, transferability (and, if so, under what circumstances), links to other digital assets, license fees, royalties and any other payment obligations. Upon transfer, an NFT’s metadata assures that required payments are accepted and confirmed, the correct payment amount is transferred to the seller, and any license fee or royalty amount is deducted from the payment made to the seller and transferred to the owner of the intellectual property.

GENERAL TAX RULES FOR CRYPTOCURRENCY

We do not have much official guidance directly on point with respect to NFTs and nonconvertible cryptocurrency. The first point of reference is Notice 2014-21¹ and the 2019 Frequently Asked Questions (“FAQs”), which were the IRS’s first attempts

to address convertible cryptocurrency taxation.² Convertible cryptocurrency has an equivalent value in real currency, can be purchased for or exchanged into real currency, and can be used to buy goods and services. For example, BTC and ETC are convertible cryptocurrencies. The IRS treats convertible cryptocurrency as property, not currency. As a result, the general tax principles that apply to property transactions apply to convertible virtual currency.

We must next consider applying these general tax rules to nonconvertible cryptocurrency and NFTs. Although Notice 2014-21 does not address nonconvertible cryptocurrencies or NFTs, it is likely – although not free from doubt – that many other cryptocurrencies and tokens (including NFTs) are the same as convertible cryptocurrency. They would be treated as property for tax purposes.

ERISA REQUIREMENTS FOR RETIREMENT PLAN AND IRA FIDUCIARIES

The Employee Retirement Income Security Act of 1974, as amended (“ERISA”) requires a plan fiduciary to discharge his or her duties solely in the interest of the plan’s participants and beneficiaries. The plan fiduciary must act with the care, skill, prudence and diligence that a prudent person familiar with such matters would use in similar circumstances. This “prudent expert standard of care” requires plan fiduciaries to consult with appropriate experts when making investment decisions if the fiduciary lacks the necessary expertise. Plan fiduciaries also owe an ongoing duty of care, which requires them to continuously monitor a plan’s investments and remove imprudent investments. Plan fiduciaries must diversify plan investments to protect the plan from the risk of large losses, unless it is clearly prudent not to do so under the circumstances.

Retirement plan fiduciaries are held accountable for complying with the ERISA fiduciary standards by the DOL. In addition, plan participants can sue plan fiduciaries for failing to comply with their ERISA fiduciary duties by selecting imprudent investments or for failing to monitor or replace imprudent investments under a defined contribution plan.

COLLECTIBLES

As of the date of this writing, the only explicit restriction on permissible investments for qualified

retirement plans and IRAs is with respect to “collectibles.” Collectible are defined in Section 408 of the Internal Revenue Code of 1986, as amended (the “Code”). They include artwork, rugs, antiques, metals or gems, stamps and coins (with certain exceptions for gold, silver and platinum coins), alcoholic beverages, musician instruments, historical objects or other tangible personal property identified by the IRS. A retirement plan investment in a collectible is automatically treated as a taxable distribution to the participant or IRA owner at the time the collectible investment is made. This deemed tax distribution applies for tax purposes, even if an actual distribution is not available to the plan participant or IRA owner. Virtual currencies can be distributed in-kind, or they can be sold, and the cash received can be distributed. Regardless of the form of distribution, however, the trustee of the retirement plan or the custodian of the IRA is required to issue a Form 1099-R to the participant/owner to report the fair market value of the collectible as taxable income in the year it is acquired by the retirement plan or IRA.

Convertible virtual currencies (such as BTC and ETH) are not “collectibles” under Code Section 408 because they are fungible and can be purchased and sold for cash or certain other virtual currencies in the same manner as stocks and other investments. Certain types of NFTs are like artwork, however, and are more likely to meet the definition of a collectible. They are unique, can be art works, cannot be easily valued and cannot be traded like convertible virtual currency.

To date, the IRS has not issued any guidance to clarify whether certain types of NFTs are collectibles that would prohibit retirement plans and IRAs from investing in them.

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RETIREMENT PLANS

Compliance Assistance Release No. 2022-01 is the first guidance from the DOL on the appropriateness of cryptocurrencies or NFTs as plan

investments. While the DOL did not outright ban retirement plans from investing in cryptocurrencies, the DOL cautioned 401(k) plan fiduciaries to “exercise extreme care” before allowing participants to invest plan assets in cryptocurrencies because cryptocurrencies “present significant risks and challenges to participants’ retirement accounts, including significant risks of fraud, theft, and loss.”

The DOL questions whether 401(k) plan fiduciaries can act consistent with their ERISA fiduciary duties if participants are allowed to invest their plan accounts in cryptocurrencies because of the “highly speculative” nature of cryptocurrencies and the “extreme price volatility” that cryptocurrencies have experienced in recent years.

Many plan participants are now aware of cryptocurrency and its reputation for “outsized profits” but lack sufficient knowledge to evaluate the risks and make informed decisions about investing retirement plan assets in cryptocurrencies. Cryptocurrencies can be particularly problematic investment if they are included as an option on a 401(k) plan’s investment menu (as opposed to being a permissible investment through a plan’s brokerage window) because inclusion on the investment menu can lead plan participants to infer that cryptocurrencies are a prudent means of investing their retirement savings despite the significant risks noted by the DOL.

Cryptocurrencies can pose unique challenges for custodial and recordkeeping. Custodial virtual currencies requires a sophisticated technology platform that is different from the custody capabilities required to hold physical assets and more traditional investments. In addition, cryptocurrencies can be difficult to reliably and accurately value.

Plan fiduciaries should also take the evolving regulatory framework for cryptocurrencies into account when deciding whether cryptocurrencies are a prudent plan investment.

To protect the interests of 401(k) plan participants and beneficiaries, the DOL announced that it intends to conduct an investigation initiative for 401(k) plans that offer cryptocurrency investments. This initiative will focus on whether including cryptocurrencies as an option on a plan’s investment menu or allowing participants to invest in cryptocurrencies through the plan’s brokerage window is consistent with the fiduciary duties that ERISA requires of plan fiduciaries.

As of the date of this writing, virtual currencies do not make up a significant amount of qualified retirement plan investments. This is true, whether they are investment options under participant-directed defined contribution plans (that is, 401(k) plans or 403(b) plans) or as investments under defined benefit plans (that is, pension plans). The DOL's guidance and upcoming investigation initiative is likely to reduce interest in using cryptocurrencies as retirement plan investments.

IRAS

Virtual currencies are currently seen by many IRA owners as attractive investments. As with other investments, earnings on virtual currencies held by IRAs can grow tax-deferred (under traditional IRAs) or tax-free (under Roth IRAs).

While IRA owners must act in a fiduciary capacity when selecting investments for their IRAs, the DOL's recent guidance does not appear to extend to IRAs invested in cryptocurrencies. Nevertheless, IRA owners should exercise caution in selecting cryptocurrencies as investments for their IRAs given the risks noted by the DOL.

An added challenge for IRA owners is ensuring the trustee or custodian for their IRA meets the IRS' custody requirements for holding IRA assets. Nonbank entities or trust companies that want to custody virtual currencies for IRAs need special approval from the IRS to do so. Code Section 408 and its related regulations set out the type of information that such an entity must demonstrate to the IRS to be approved to hold assets for an IRA.

CONCLUSION

As interest in investing in cryptocurrencies grows, retirement plan fiduciaries need to understand the fiduciary duties owed to the plan's participants and beneficiaries. Investment of retirement plan assets in cryptocurrencies must be carefully evaluated by plan fiduciaries in light of the risks inherent in cryptocurrency investments in the current market. In addition, plan fiduciaries must be aware of any new tax developments.

Notes

1. 2014-16 I.R.B. 938.
2. IRS, Frequently Asked Questions, 2019, most recently updated March 2021.

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