Cryptocurrency Investing by Retirement Plans and IRAs

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It is difficult to ignore news reports that the price of bitcoin and other cryptocurrencies is soaring. As of this writing, bitcoin is trading at almost $63,000 which is an increase of over $50,000 since July 2020. A cryptocurrency called Shiba Inu, which was created in August 2020 by an anonymous person or persons known as “Ryoshi,” is up more than seven million percent since its debut in August 2020. One crypto investor bought $8,000 worth of Shiba Inu coins in August 2020, and just over a year later, his coins were worth an astounding $5.7 billion.1

With reports like these, it is no wonder that plan fiduciaries, employees and retirees are asking whether retirement plan assets may be invested in cryptocurrency. Despite the financial upside, cryptocurrency investments present significant risk and, for plan fiduciaries, legal exposure, as described in this column.

What is a Cryptocurrency?

There are literally thousands of cryptocurrencies that have been created. Certainly, the most well-known is bitcoin. If an investor owns a
bitcoin, it is tracked on a “blockchain” which is, essentially, a ledger that is distributed to all bitcoin users and which is constantly updated to reflect transactions. Any time a transaction occurs, the blockchain is updated. Each bitcoin is identified on the blockchain by a “public key” which is essentially a code that has been assigned to the bitcoin. The user, however, remains anonymous. To own a bitcoin and to be able to use and control it, one must also have a “private key” or a code which is known only to the user. Users may store their private key on the internet, on their computer, on a USB or flashdrive, or with third parties.

**Applicable Law**

Qualified retirement plans are governed by the Employee Retirement Income Security Act of 1974, as amended (“ERISA”) and the Internal Revenue Code of 1986, as amended.

Generally, neither law dictates what specific investment options may be held in a retirement plan. ERISA, however, requires plan fiduciaries (i.e., the persons who control the operation and management of the plan) to comport with certain standards of conduct.

Under ERISA, a plan fiduciary must act “with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” This is a very high standard of conduct and requires plan fiduciaries to act like prudent experts. To satisfy this duty, when confronted with a decision, plan fiduciaries must:

- Gather relevant information;
- Analyze the information;
- Seek expert advice, such as from investment advisors and ERISA counsel; and
- Make a well-reasoned decision based on the gathered information.

Importantly, this duty also requires plan fiduciaries to consider the “circumstances then prevailing.” In other words, as the world becomes more complex and facts change, a plan fiduciary is required to revisit and reconsider earlier decisions.

Another important fiduciary duty under ERISA requires fiduciaries to act for the exclusive purpose of providing retirement benefits to plan participants and to discharge their duties solely in the interest of plan participants. ERISA describes these duties as follows: “A fiduciary shall discharge his duties with respect to a plan solely in
the interest of the participants and beneficiaries and: (A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries.”

Thus, a plan fiduciary, when confronted with a decision, must always place the interests of the plan participants ahead of everything else (e.g., their own interests or the plan sponsor’s interests). This fiduciary duty is sometimes referred to as the “duty of loyalty.”

Plan fiduciaries who breach their fiduciary duties are personally liable to make good to the plan any losses resulting from such breach, and to restore to the plan any profits which have been made through the use of plan assets by the fiduciary.

The U.S. Department of Labor (“DOL”) has recently issued an information letter which provides advice to plan fiduciaries who are considering offering private equity investments under their 401(k) plan. Broadly construed, the DOL letter also provides guidance for plan fiduciaries who are considering cybersecurity investments. The letter instructs plan fiduciaries to consider a variety of issues when evaluating the risks and benefits of an investment, such as:

- Whether the investment offers plan participants a diversified investment within an appropriate range of expected returns, net of fees.
- Whether the investment manager has the appropriate capabilities and experience to manage the investment effectively.
- Whether the investment fund limits investments in a way that adequately addresses issues related to cost, complexity, and liquidity.
- Whether the investment aligns with the plan’s investment policy statement and meets the needs of plan participants in light of the plan’s features and the profiles of plan participants.
- Whether adequate information about the investment is available to plan participants so that they may make informed decisions.

Turning to the Internal Revenue Code, the IRS does not treat cryptocurrency, despite its moniker, as a currency. As such, it does not generate foreign currency gain or loss for federal income tax purposes. Instead, the IRS treats cryptocurrency as property. Therefore, an individual investor must recognize gain or loss on the sale of cryptocurrency for cash (or other property).

Normally, cash proceeds received from the sale of cryptocurrency that has been held for one year or less generates short-term capital gain (or loss) and proceeds received from the sale of cryptocurrency held for more than one year generates long-term capital gain (or loss).
Further, if a taxpayer receives cryptocurrency as payment for goods or services, the taxpayer must include in gross income the fair market value of the cryptocurrency (measured in U.S. dollars) as of the date that the cryptocurrency was received. Cryptocurrency that is held inside a retirement plan or IRA would generally be subject to the same tax-deferred treatment as any other investment held within a retirement plan or IRA and, upon distribution, would be subject to ordinary income taxation. However, if cryptocurrency is held within a Roth 401(k) account or a Roth IRA, the potentially immense gains generated by a cryptocurrency investment would escape taxation as long as the withdrawal is a qualified distribution.

**Risks of Investing in Cryptocurrency**

Although ERISA does not prohibit retirement plans from investing in cryptocurrency, a plan fiduciary must abide by its ERISA fiduciary duties. Thus, a fiduciary must prudently consider the risks of investing in cryptocurrency before investing pension plan assets in cryptocurrency or offering cryptocurrency as an investment option under a 401(k) plan. Some of the risks are described below.

**Custodial Risks**

Financial institutions must be able to properly record-keep, custody and value cryptocurrency within a retirement plan. To be sure, cryptocurrencies are not like stock and bonds which can be easily held in a custodial account. Custodial valuation is also a concern as cryptocurrency transactions often occur 24 hours a day. There is no market closing price on which transactions can be based. To our knowledge, there are not many 401(k) administrators who offer cryptocurrency investments. Should cryptocurrency investments become more widespread among retirement plans, it will likely be through the development of collective investment funds or ETFs that are investment primarily or exclusively in a broad range of cryptocurrency. As these collective investments develop, and some are currently waiting for approval by the Securities and Exchange Commission, it may lessen the custodial risk of cryptocurrency investments.

**Cybersecurity Risks**

The blockchain technology backing many cryptocurrencies is typically quite secure due to the public and decentralized nature of the ledger and the encryptions that apply to every cryptocurrency transaction. However, some cryptocurrency marketplaces and storage facilities may be subject
to infiltration and hacks. Another issue is that private keys are very similar to bearer paper. Meaning, if a key is lost or stolen, it will likely be very difficult to recover.

**Volatility and Liquidation**

The price of any cryptocurrency may drop precipitously on any given day or may swing significantly over any time period. This volatility is driven by a variety of factors, including the changing perceptions of investors, social media hype, bad national or global news (such as China souring on cryptocurrency) and the uncertainty of its future. Liquidity is also an important issue. Some marketplaces may have low trading volume, so sellers and buyers may not get the price they want at the time they want it. Other marketplaces may restrict the amount of cash that an investor may deposit or withdraw.

**Regulatory Risk**

Cryptocurrencies are not under the direct control of any government or bank and, so far, are subject to very little regulation. Both the lack of current regulation and the possibility of future regulation are risks. In a recent speech, Gary Gensler, the head of the Securities and Exchange Commission, decried the absence of clear regulations, and promised that the SEC will use its power to protect investors.\(^\text{10}\) It remains to be seen whether future regulations will assure investors of transparent pricing and proper government oversight, thereby encouraging investment in cryptocurrency, or whether the regulations will have the opposite effect of discouraging cryptocurrency investment. Theoretically, future regulations could prohibit or limit cryptocurrency investments by retirement plans and IRAs.

**Individual Retirement Accounts**

Individual retirement account ("IRA") investments give rise to many issues, including prohibited transactions and unrelated business taxable income. However, neither IRAs nor their owners are subject to ERISA, including ERISA’s fiduciary standards.

Moreover, the Internal Revenue Code generally permits IRAs to invest in anything other than life insurance\(^\text{11}\) and collectibles.\(^\text{12}\) Accordingly, it is not surprising that most retirement plan investors who want to invest in cryptocurrency have done so through their IRAs.

Cryptocurrency, in part, derives its value from public perception, scarcity and demand so one may inquire whether it is a “collectible” and, therefore, a prohibited investment. A “collectible” is defined to include any work of art, any rug or antique, any metal or gem, any stamp or coin
(other than certain coins and bullion described under Section 408(m) (3) of the Code), any alcoholic beverage, or any other tangible personal property specified by the Secretary of the Treasury. To our knowledge, the Secretary of the Treasury has not issued any guidance on whether a cryptocurrency “coin” is a collectible. However, all of the items listed as collectibles are items of “tangible personal property” and, on this point, the Internal Revenue Service has stated that “tangible personal property” is “anything other than real property or intangible personal property which includes items such as patents, copyrights, stocks, and the goodwill value of a business.”

Further, the Tax Foundation generally describes “tangible personal property” as comprising of “property that can be moved or touched, and commonly includes items such as business equipment, furniture, and automobiles. This is contrasted with intangible personal property, which includes stocks, bonds, and intellectual property like copyrights and patents.” Moreover, cryptocurrency would appear to be intangible assets under U.S. GAAP since they lack physical substance and are not financial assets such as cash. As cryptocurrency is likely an intangible asset, it would not appear to be a collectible under the Internal Revenue Code.

**Benefits of Investing in Cryptocurrency**

Clearly, the potential for significant wealth accumulation is the primary benefit of investing in cryptocurrency, but there may be other benefits. For example, retirement plan sponsors may wish to evaluate investing in cryptocurrency based on participant demand or the desire to attract talent in a time when many employers are struggling to hire. Offering cryptocurrency under a 401(k) plan would also relieve employees of the headaches and burden of holding and trading cryptocurrency for themselves.

Further, sponsors of defined benefit pension plans may wish to consider cryptocurrency in an effort to improve their plan’s funding status. Such sponsors generally need not fear fiduciary liability for cryptocurrency losses if they are willing to make the plan whole through increased contributions.

**Conclusion**

Cryptocurrency is certainly an alluring investment opportunity because of the potential to make substantial profits, but sponsors of retirement plans need to tread carefully before allowing plan assets to be invested in cryptocurrency. Although nothing explicitly prohibits plan fiduciaries from offering cryptocurrency under a retirement plan, the numerous risks associated with cryptocurrency will likely cause many plan fiduciaries to conclude that cryptocurrency is not a proper plan investment.
Employees and retirees, however, can still invest in cryptocurrency through their IRAs as there is no legal prohibition against doing so, although such employees and retirees should evaluate the risks and obtain qualified advice before making such an investment.

Notes

2. ERISA § 404(a)(1)(B).
4. ERISA § 409(a).
7. Id.
8. Id.
9. A “qualified distribution” is generally a distribution that is made after a five-taxable-year period of participation and is either (i) made on or after the date the participant attains age 59 1/2; (ii) made after the participant’s death; or (iii) attributable to the participant being disabled. IRC § 402A(d).
11. IRC § 408(a)(3).
12. IRC § 408(m)(1).
13. IRC § 408(m)(2).