Bloomberg Tax

Tax Management
Compensation Planning Journal™

Crypto and Digital Currencies Are Here to Stay: But Are They Welcome in Your 401(k)?

By G'Nece Jones, Esq., LL.M.[*]
Ballard Spahr LLP
Philadelphia, PA

Cryptocurrencies ("crypto" or "digital currencies" used interchangeably) are all the rage and many plan sponsors have responded to demands to include digital assets as plan investment options within job-sponsored retirement plans. In June 2021, ForUsAll, a retirement investment platform for small businesses, announced that it will offer 50 different crypto assets, including bitcoin, that will enable employers to offer cryptocurrency as retirement fund investments; allowing participants to allocate up to 5% of their retirement funds in cryptocurrency.[1] Some investment firms offer self-directed Individual Retirement Accounts that can invest in hard assets and digital assets, such as various cryptocurrencies.[2] Most recently, Fidelity Investments announced on April 26, 2022, that it will allow 401(k) plan participants to direct a portion of their retirement savings into bitcoin, up to a cap of 20%.[3]

Even various public pensions, historically very conservative in their investment allocations, have announced their desire to invest heavily in cryptocurrencies.[4] The Fairfax County Police Officers' Retirement System and the Fairfax County Employees' Retirement System are planning to invest a total of $50 million in Parataxis Capital Management LLC's main fund, which buys various digital tokens and cryptocurrency derivatives.[5] In October 2021, the Houston Firefighters' Relief and Retirement Fund announced that it had purchased bitcoin for its defined benefit plan's portfolio.[6]

This article will focus on cryptocurrencies in the retirement plan context. It is not intended to substantively address the myriad of regulatory issues such as

---

[*] G'Nece Jones advises plan sponsors on various benefit plan issues related to plan design, administration, maintenance of tax-qualified status, tax reporting, and operational compliance matters. G'Nece assists clients in conducting due diligence efforts and drafting contracts with insurers, annuity providers, HIPAA-related covered entities and business associates, and other vendors. She also drafts plan documents, summary plan descriptions, and other communications to ensure that plans efficiently discharge their fiduciary duties related to plan disclosure and reporting.

This article may be cited as G'Nece Jones, *Crypto and Digital Currencies Are Here to Stay; But Are They Welcome in Your 401(k)?*, 50 Tax Mgmt. Comp. Plan. J. No. 5 (May 6, 2022).

[1] Tanaya Macheel, *This Small 401(k) Provider Wants to Bring Cryptocurrency to Americans' Retirement Funds*, CNBC (June 10, 2021).

[2] See, for example, BitIRA.

[3] Anne Tergesen, *Fidelity to Allow Retirement Savers to Bitcoin in 401(k) Accounts*, The Wall Street Journal (Apr. 26, 2022).

[4] Queensland Investment Corporation (QIC), Australia's fifth-largest pension fund managing nearly $70 billion worth of assets, is reportedly open to investing in cryptocurrencies in the future.

[5] Olga Kharif, *Virginia Public Pension Make a Direct Bet on Cryptocurrencies*, (Sept. 10, 2021). *See also Crypto Derivatives 101: A Beginner's Guide on Crypto Futures, Crypto Options and Perpetual Contracts*, Cointelegraph.com, stating that:

> A derivative is any product or contract with a value determined by an underlying asset. In traditional financial markets, derivatives derive their value from assets such as stocks, bonds, interest rates, commodities, fiat currencies, and cryptocurrencies, hence the name. Crypto derivatives work like traditional derivatives in the sense that a buyer and a seller enter into a contract to sell an underlying asset. Such assets are sold at a predetermined time and price. As such, derivatives do not have an inherent value but rely on the value of the underlying asset. For example, an Ethereum derivative relies on and obtains value from the value of Ethereum. Derivative trades also do not hold nor own the underlying asset. The most popular types of derivatives in crypto are futures, options and perpetual contracts.

[6] Namicos-Bitcoin Magazine, *US Public Pension Fund Invests in Bitcoin for the First Time*, Nasdaq.com (Oct. 21, 2021).

ISSN 0747-8607

whether crypto is a security, registration issues, and other concerns issues.

THE WHITE HOUSE AND THE U.S. DEPARTMENT OF LABOR WEIGH IN

With mounting pressure for some formalized regulation of cryptocurrencies, The White House and the U.S. Department of Labor (DOL) have recently stepped in and provided much needed guidance. While President Biden's Executive Order acknowledges the risks associated with digital assets, the tone of the order is much more welcoming than the position taken by the DOL.

On March 9, 2022, President Biden issued the *Executive Order on Ensuring Responsible Development of Digital Assets* (EO). The EO requires federal agencies, including the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and the Federal Trade Commission (FTC) to examine and prepare policy recommendations, including regulatory and legislative changes, to protect U.S. consumers, investors, and businesses, and support expanding access to safe and affordable financial services. In an effort to maintain the ''continued centrality of United States within the international financial system,'' the EO also laid out the president's plan to develop the U.S. Central Bank Digital Currencies (U.S. CBDC),[7] and cultivate technological advances that promote responsible development and use of digital assets, amongst other goals.[8]

On March 10, 2022, the DOL issued guidance which cautioned fiduciaries pondering the inclusion of cryptocurrencies in their 401(k) plan investment lineups.[9] The DOL's Compliance Assistance Release No. 2022-01 expressed serious concerns about the prudence of a fiduciary's decision to expose a 401(k) plan's participants to direct investments in cryptocurrencies or other products whose value is tied to cryptocurrencies.[10] Although the Treasury did not specify what such ''other products'' are, they are likely to include, Non-Fungible Tokens (NFTs), stock in companies which invest in blockchain technology, cryptocurrency derivatives, or companies that provide a cryptocurrency exchange whereby investors may buy and sell cryptocurrency. It may also include Exchange Traded Funds (ETFs) that invest in futures contracts in cryptocurrencies.[11] The DOL Compliance Assistance Release No. 2022-01 reasoned that cryptocurrencies are too new to have developed a track record reliable enough to prove itself as a prudent investment vehicle.[12] Specifically, the DOL Compliance Assistance Release No. 2022-01 set forth five separate reasons why it deemed crypto too risky to expose to plan participants:

Speculative and Volatile

Cryptocurrency is subject to ''extreme price volatility,'' which the DOL believes is linked to the uncertainties associated with valuing these assets, including the amount of fictitious trading reported, highly publicized incidents of theft and fraud, among other factors.[13] The DOL opined that such factors could devastate the retirement account balances of plan participants, especially those approaching retirement, and those with substantial allocations to cryptocurrency. In fact, when Fidelity recently publicized its move to allow investors to put bitcoin in their 401(k) accounts, the DOL's acting assistant secretary of EBSA expressed his ''grave concerns,'' about how this will impact the retirement savings of the average American investor.[14]

The White House is similarly concerned with the protection of digital assets and the exchanges upon which they are traded, and the digital ''wallets'' in which they are held. In addition to fraud and theft, the EO lists other vulnerabilities associated with cryptocurrencies and their related platforms; namely statutory and regulatory violations, privacy and data breaches, unfair and abusive acts or practices, and other cyber incidents faced by consumers, investors,

---

[7] The first step in the creation of a U.S. issued digital currency was taken on March 28, 2022, in which H.R. 7231, the Electronic Currency and Secure Hardware Act (ECASH Act), was introduced in the United States House of Representatives. See Adam Singer, US e-cash: Bill proposes digital currency that replicates cash, bypasses the Fed (Mar. 28, 2022). According to Representative Stephen Lynch, Chair of the Fintech Task Force in the House Financial Services, the ECASH Act aims to enhance consumer protection and data privacy. However, ''e-cash'' would be issued by the Treasury, not the Federal Reserve Board, which means it would technically not be a central bank digital currency (CBDC); nor would it be built on a blockchain or require the internet to operate.

[8] EO on Ensuring Responsible Development of Digital Assets (Mar. 9, 2022), §1, §2, and §4.

[9] DOL, Compliance Assistance Release No. 2022-01, 401(k) Plan Investments in ''Cryptocurrencies'' (Mar. 10, 2022).

[10] *Id.*

[11] Futures contracts in cryptocurrencies are regulated by the Commodities Future Trading Commission.

[12] ''These assets are for people's old age, and we really are very serious about making sure that this money is invested and recommendations are made in people's best interest,'' Ali Khawar, acting assistant secretary at the U.S. DOL — Employee Benefits Security Administration (EBSA), as quoted by Tara Siegel Bernard, *The Labor Department Wants to Investigate Crypto in Retirement Plans*, The New York Times (Mar. 10, 2022).

[13] DOL Compliance Assistance Release No. 2022-01.

[14] See Note 3, above.

ISSN 0747-8607

and businesses.[15] The EO acknowledged the critical roles that the SEC, CFTC, Consumer Financial Protection Bureau (CFPB), and the Federal Reserve play in establishing protections within the financial system which serve to ''safeguard its integrity and promote its stability.''[16] In an effort to mitigate the risks associated with digital assets, and to gain a better understanding of how the growth of digital assets will impact financial systems, the EO mandates the submission of various multi-agency reports regarding cryptocurrencies. Specifically, within 210 days from March 9, 2022, the EO directs the Secretary of Treasury to convene the Financial Stability Oversight Council (FSOC) and produce a report discussing the ''specific financial stability risks and regulatory gaps posed by various types of digital assets and providing recommendations to address such risks.''[17]

Additionally, within 180 days from March 9, 2022, the EO instructs:[18]

- The Secretary of Treasury (in consultation with the Secretary of Labor and the heads of the FTC and the SEC) to submit a report on how digital assets may impact the financial market and payment system infrastructures. The order requires that this report explore the conditions driving mass adoption of different types of digital assets and the risks and opportunities associated with such growth. Additionally, the order requests that the report include policy recommendations, including potential regulatory and legislative actions to protect U.S. consumers, investors and businesses.
- The Director of the Office of Science and Technology Policy and the Chief Technology Officer of the United States, in consultation with the Secretary of the Treasury and other relevant agency heads must submit to the President a technical evaluation of the technological infrastructure and expertise needed to support introduction of a CBDC system. The evaluation will specifically address the technical risks of various designs, including quantum computing.[19]
- The Chairpersons of the SEC, CFTC,[20] Federal Reserve, and the Board of Directors of the Federal Deposit Insurance Corporation are encouraged to consider the ''extent to which investor and market protection measures within their respective jurisdictions may be used to address the risks of digital assets and whether additional measures may be needed.''[21]

Difficulty for Plan Participants to Make Informed Investment Decisions

The DOL is concerned that the discussion surrounding cryptocurrency appears to overestimate their potential for ''outsized profits,'' but fails to highlight the substantial risks associated with such investments. It notes that ''it can be extraordinarily difficult, even for expert investors, to evaluate these assets and separate the facts from the hype.''[22] This, coupled with the fact that the average participant in a 401(k) plan is unlikely to have sufficient knowledge about cryptocurrencies to make informed decisions, as compared to traditional investments, makes the role of plan fiduciaries as gatekeepers protecting their respective plans from risky and volatile investments such as cryptocurrency that much more important. The DOL explained that when plan fiduciaries choose to include a cryptocurrency option in a 401(k) plan, they are sending a nonverbal cue that tells participants that knowledgeable investment experts approve that option as prudent; which can easily lead participants astray and cause losses.[23]

Custodial Recordkeeping Concerns

According to the DOL, the unique nature of crypto renders it unable to be held in trust or custodial accounts ''readily valued and available to pay benefits

---

[15] EO on Ensuring Responsible Development of Digital Assets, §5.

[16] *Id.* at §6 (discussing the Treasury's Financial Stability Oversight Council (FSOC) which assess the financial stability and regulatory gaps posed by digital assets).

[17] *Id.* at §6.

[18] This not an exhaustive list of the various reports requested by the EO.

[19] *Id.*

[20] Sam Bankman-Fried, the co-founder and CEO of FTX, a crypto trading platform, recently advocated for a larger role for the CFTC to regulate the crypto industry. Although the CFTC is a relatively small agency which monitors futures contracts in basic goods such as oil, corn, and financial derivatives such as interest-rate swaps, it also oversees U.S. futures and option contracts on cryptocurrencies bitcoin and ether. Specifically, Bankman-Fried ''wants Congress to expand the CFTC's authority to cover trading in the coins themselves. Currently, the CFTC only claims jurisdiction over cash token markets in cases of suspected fraud or manipulation that could affect the performance of crypto derivatives. In February testimony to the Senate, he said this lack of clarity is bad for investors and the industry. Other trading platforms are also starting to see the merits of being overseen primarily by the CFTC, say industry leaders who asked not to be named talking about private discussions.'' Robert Schmidt and Allyson Versprille, *Crypto Platforms Ask for Rules But Have a Favorite Watchdog*, Daily Tax Rep. (Mar. 31, 2022).

[21] EO on Ensuring Responsible Development of Digital Assets, §5.

[22] DOL Compliance Assistance Release No. 2022-01.

[23] *Id.*

ISSN 0747-8607

and plan expenses,'' unlike traditional assets.[24] However, there are currently several companies that offer custodial accounts that support cryptocurrency. In July 2020, Kingdom Trust executed an institutional agreement which appointed Fidelity Digital Assets as the bitcoin custodian for its Choice retirement account.[25] As part of the agreement, Choice members who elect this arrangement ''will not have to manage their own private keys but will choose to have bitcoin held in cold storage exclusively by Fidelity Digital Assets.''[26] Then on October 5, 2021, U.S. Bank announced that it would partner with New York Digital Investment Group to begin providing cryptocurrency custody services to institutional investment managers with private funds in the United States or Cayman Islands seeking a safekeeping solution for bitcoin.[27] Additionally, on March 29, 2022, an investment technology platform, Onu, announced new functionality that allows parents to create cryptocurrency custodial accounts for their children.[28]

Because cryptocurrencies are generally held in a user's private ledger (similar to a digital wallet), existing merely as ''lines of computer code,'' the DOL is concerned that if the password to the ledger is lost or forgotten, then the asset could be lost indefinitely. Additionally, the DOL notes that other methods of holding these assets (such as keeping them in a user's account on a cryptocurrency exchange, or in a user's digital wallet) can be vulnerable to hacking and theft.[29] These features, according to the DOL, render cryptocurrency an inappropriate currency for payment of retirement plan benefits or expenses; a cornerstone requirement of the Employee Retirement Income Security Act of 1974, as amended (ERISA).[30]

Valuation Concerns

The DOL Compliance Assistance Release No. 2022-01 is critical of the proposed methodologies for valuing cryptocurrencies, stating that they are not as ''sound or as academically defensible as traditional discounted cash flow analysis.'' Additionally, the DOL is skeptical that crypto market intermediaries (such as exchanges, and other platforms whereby cryptocurrencies can be traded, and in some cases, loaned out to various users while accruing interest) will adopt consistent accounting procedures and may not be subject to the same data integrity requirements with respect to pricing as would more traditional investment products.[31]

Evolving Regulatory Landscape

The DOL instructs plan fiduciaries who are considering the addition of cryptocurrencies in their plan lineups to analyze how regulatory requirements will apply to their decision to issue, invest, trade, and to conduct other activities related to the cryptocurrency asset.[32] For instance, the sale of some cryptocurrencies could be deemed an unlawful sale of securities in unregistered transactions. Recently, the SEC rejected a filing for an ETF that would have invested directly in cryptocurrencies.[33] Additionally, the SEC announced charges against BlockFi Lending LLC (BlockFi) with respect to its BlockFi Interest Account product.[34] The evolving regulatory landscape of crypto will not allow plan fiduciaries to skirt their fiduciary duties with respect to the plans that they are tasked with protecting. The DOL requires that plan fiduciaries ''take care to avoid participating in unlawful transactions, exposing themselves to liability and plan participants to the risks of inadequate disclosures and the loss of investor protections that are guaranteed under the securities laws.''[35] Quoting FINRA's warning that bitcoin and other cryptocurrencies have been used in illegal activities including money laundering and drug dealing, the DOL worries that law enforcement agencies could restrict the use of platforms and exchanges; which would effectively neutralize the liquidity of such assets,[36] further militating against inclusion of crypto as ERISA plan assets.

---

[24] *Id.*

[25] *Kingdom Trust Appoints Fidelity Digital Assets (SM) To Power Bitcoin Custody For Choice Retirement Accounts*, PRNewswire (July 14, 2020).

[26] *Id.*

[27] *U.S. Bank Announces New Cryptocurrency Custody Services for Institutional Investment Manager* (Oct. 5, 2021).

[28] *Onu Launches First-Ever Crypto Custodial Accounts,* PRNewsire (Mar. 29, 2022).

[29] DOL Compliance Assistance Release No. 2022-01.

[30] DOL Compliance Assistance Release No. 2022-01. Pub. L. No. 93-406, ERISA §404.

[31] DOL Compliance Assistance Release No. 2022-01.

[32] *Id.*

[33] Vildana Hajric and Katherine Greifeld, *SEC Rejects VanEck's Bitcoin ETF in Latest Spot-Listing Snub*, Bloomberg (Nov. 12, 2021).

[34] According to the SEC, investors lent crypto assets to BlockFi through the BlockFi Interest Accounts (BIAs). BlockFi used investors' crypto assets to make investments, including loans to institutional investors, and investors received interest paid monthly in crypto assets. The SEC's order found that the BIAs were securities and BlockFi did not register its offering of the BIAs. In addition, according to the order, BlockFi made a materially false and misleading statement on its website concerning its collateral practices, thus understating the degree of risk in its lending program. Further, the SEC found that BlockFi operated as an unregistered investment company due to the amount of investment securities it held. SEC, Investor Bulletin: Crypto Asset Interest-Bearing Accounts (Feb. 14, 2022).

[35] DOL Compliance Assistance Release No. 2022-01.

[36] Megan McDermott, *The Crypto Quandary: Is Bankruptcy*

ISSN 0747-8607

Based on these concerns, EBSA expects to conduct an investigative program aimed at plans that offer participant investments in cryptocurrencies and related products. The DOL further warned plans which offer crypto to plan participants through brokerage windows, should anticipate questioning by the DOL about "how they can square their actions with their duties of prudence and loyalty in light of the risks" described herein.

IRS Guidance Discusses the Unique Nature of Cryptocurrencies

Another example of the unique nature of cryptocurrencies is their ability to undergo a "forking" event. Cryptocurrencies are governed by decentralized open-source software called a "blockchain."[37] When there is a change to the blockchain's underlying protocol, a fork occurs. A blockchain fork can either represent a minor change (a "soft fork"), or it could be a radical change (a "hard fork") which often results in a new currency.[38] Bitcoin underwent a hard fork on August 1, 2017, which resulted in the creation of a new cryptocurrency, Bitcoin Cash.[39] The developers of Bitcoin Cash designed the Bitcoin Cash protocol in such a way that the holders of bitcoin received Bitcoin Cash in a 1:1 ratio. Thus, "at the time the new Bitcoin Cash protocols went into effect, Bitcoin Cash was effectively distributed to all distributed ledger addresses that held Bitcoin," as of the time immediately preceding the forking event.[40] This sudden creation of a new cryptocurrency created uncertainty with regard to the tax implications of individuals who now owned Bitcoin Cash.

On March 22, 2021, the IRS released CCA 202114020 describing the tax consequences for individuals who received Bitcoin Cash as a result of the hard fork. The IRS confirmed that taxpayers who received Bitcoin Cash as result of the August 1, 2017, bitcoin hard fork received gross income because the taxpayer experienced an "undeniable accession to wealth" under §61.[41] Specifically, the date on which taxpayers receive such gross income, and the fair market value to be included in income depends on when the taxpayer obtained "complete dominion" and control over their Bitcoin Cash.[42] The IRS explained that some taxpayers holding bitcoin through hosted wallets at cryptocurrency exchanges did not have dominion and control over their new Bitcoin Cash at the time of the hard fork.[43] For example, the cryptocurrency exchange, Coinbase, began supporting Bitcoin Cash six months later, on December 19, 2017.[44] Prior to that date, Coinbase customers were unable to trade Bitcoin Cash through their Coinbase accounts, therefore they lacked actual or constructive control over their Bitcoin Cash.

A retirement plan's decision to support a new cryptocurrency resulting from a hard fork may be considered a fiduciary decision subject to the prudent deliberation requirements of ERISA. In CCA 202114020, the IRS provided an example of a cryptocurrency exchange which elected to delay its support of Bitcoin Cash because of the uncertainty surrounding its "security and long term viability." To the extent that ERISA covered retirement plan fiduciaries are tasked with the decision of exposing plan participants to these new cryptocurrencies, fiduciaries should anticipate that every aspect of this decision-making process will be subject to the watchful eye of plan participants and the DOL. For instance, if a plan fiduciary decides to delay participants' access to a new hard-forked cryptocurrency in order to thoroughly analyze it, and the cryptocurrency's value skyrockets during the interim, plan participants may allege a fiduciary breach caused them to miss out on this windfall. Plan fiduciaries may wish to consider providing participants with a brief disclosure explaining the reasons for the delay, and any risks or security concerns identified. Additionally, plan fiduciaries would need to timely inform participants of the existence of any newly formed cryptocurrencies so that participants can begin trading in the new digital assets.

CONCLUSION

The tone of the Compliance Assistance will undoubtedly serve to chill most plan sponsors from recommending and offering crypto in their investment

Ready?, 115 NW. U.L. Rev. Online 24, 44 (2020) (noting that "Crypto assets . . . often present an illusionary facade of liquidity").

[37] *Soft Fork vs. Hard Fork: Differences Explained*, Cointelegraph.com.

[38] Katelyn Peters, *A History of Bitcoin Hard Forks*, Investopedia (July 13, 2021).

[39] Aaron Van Wirdum, *The Birth of BCH: The First Crazy Days of 'Bitcoin Cash*, Bitcoin Magazine (Aug. 3, 2017).

[40] CCA 202114020.

[41] CCA 202114020; see also Rev. Rul. 2019-24 which established that transactions in crypto result in taxable income. See also Notice 2014-21 in which the IRS applied general principles of tax law to determine that virtual currency is property for federal tax purposes. All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[42] Referencing *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429-430 (1955) (the Supreme Court also held that "gross income" includes all "gains or profits and income derived from any source whatsoever").

[43] CCA 202114020, n. 1.

[44] *Id.*; *see also Buy, Sell, Send and Receive Bitcoin Cash on Coinbase* COINBASE (Dec. 19, 2017).

ISSN 0747-8607

lineups. However, as the regulatory landscape becomes more established, and the ability to value crypto becomes more consistent and reliable, it is possible that the DOL may have a change of heart similar to its position on the inclusion of ESG-related investments as plan assets.[45] By that time, however, there will likely be new digital assets that will pose similar, and perhaps new policy issues which will warrant a similar cautious approach by plan sponsors. It is also likely that, if the Executive Order's prognostication is correct, plans at that time will be making distributions to participants solely in digital currency.

[45] Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, RIN 1210-AC03, 86 Fed. Reg. 57,272 (Oct. 14, 2021).

ISSN 0747-8607