Flashpoint: Cryptocurrency Holders Beware- Regulations Are Coming!

By: Alison J. Cohen

I'd like to start by clarifying that if you think this article has a bias, you are correct. Without question, I believe that cryptocurrency should not be part of a retirement plan. And now, there is no doubt that the Department of Labor ("DOL") and I agree with each other. Let's start this story at the beginning.

In the Beginning, There Was a Paper

Back in 2008, there was a paper titled "Bitcoin: A Peer-to-Peer Electronic Cash System" that was posted online, written under the pseudonym Satoshi Nakamoto (to this day, no one knows the real identity of the author). Yes, it was written anonymously, so it was super-reputable … NOT! But, it foretold the coming of a new trend that we now call "cryptocurrency." The first bitcoin network was created in 2009 and a whole new set of vocabulary words were co-opted (e.g., bitcoin "miners" don't use pickaxes and wear suspenders and floppy hats like the old Miner 49er). Fast forward several years, and to no surprise of anyone with critical thinking, bitcoin started showing up on the dark web, such as the Silk Road, and has been used for nefarious purposes. So, if you are like me and associate bitcoin with computer terrorists and criminals, this is why.

Fast forward again to 2013. Without getting uber-technical, the initial blockchain was split accidentally for a period of hours due to a bug in the software. The complications caused a huge temporary price drop and the U.S. Financial Crimes Enforcement Network (didn't even know that existed before) created the first cryptocurrency regulatory guidance, which led to the first enforcement actions. Soon, the Drug Enforcement Administration, Department of Justice, and Federal Bureau of Investigation started cracking down. By 2020, notwithstanding the interest of law enforcement and the unpredictability of this "investment," the number of cryptocurrency owners increased exponentially, and the volatility made headlines. You have to love an investment that can gain or lose more than 10% in a single day due to a Tweet.

China and India have both banned cryptocurrency. Currently, different U.S. governing agencies have different definitions of what cryptocurrency is. The Commodity Futures Trading Commission considers the exchange tokens as commodities. [*CFTC v. McDonnell*, 287 F. Supp. 3rd 213

(E.D.N.Y 2018).] The Securities and Exchange Commission ("SEC") and Congress seem to consider it a digital asset. The Internal Revenue Service ("IRS") seems to consider it to be a virtual currency. (If you want some light IRS bedtime reading, check out IRS Notice 2014-21, Revenue Ruling 2019-24, and the FAQs posted on the IRS website, which it continues to update periodically.)

Why Does it Matter What it Is?

If the IRS classifies cryptocurrency as a virtual currency, that means that it constitutes property for tax purposes. Some worried that the IRS could treat it like coins or collectibles, requiring that any plan investments in this asset be compliant with the custodial requirements of Internal Revenue Code (the "Code") section 408(a) and subject to the ban on collectibles for individually directed plans and IRAs. (Finding an appropriate custodian for cryptocurrency is a whole other bag of snakes.) The language of Notice 2014-21 and the other guidance referenced above supports the treatment as property not subject to the limitations on collectibles.

The SEC, by treating cryptocurrency as a digital asset, has initiated lawsuits for failure to adhere to securities laws and processes. Ripple Labs recently made the news as a target of the SEC for raising capital through CRYPTO XRP without making proper disclosures to the SEC. If SEC registration is required, the sponsors of the cryptocurrencies need to comply with securities regulations, which mandate that they issue reports and disclosures and adhere to the appropriate limitations. One of Ripple's legal arguments (with which I happen to grudgingly agree) is that it did not receive proper notice. With governmental guidance so vague or ambiguous, how can anyone – from issuers of cryptocurrency to the investors who purchase it – know what to do?

The Biden Administration Speaks

On March 9, 2022, President Biden signed an Executive Order directing the various federal agencies to work on comprehensive guidance and regulations on cryptocurrency, as the "first ever, whole-of-government approach." The key points of the Order include:

- Directing the Treasury and other agencies to create policy recommendations to ensure sufficient oversight and safeguards against any financial risks posed by "digital assets";
- Encouraging the Financial Stability Oversight Council to identify and mitigate economy-wide financial risks and develop appropriate policy recommendations;
- Directing all agencies to mitigate the illicit finance and national security risks posed by the illicit use of digital assets;
- Directing the Department of Commerce to promote U.S. leadership in technology and economic competitiveness;
- Appointing the Treasury to take the lead to produce a report on the future of money and payment systems, including implications for economic and financial growth, and national security;
- Directing all agencies to support technological advances, but ensure responsible development and use of digital assets; and
- Directing the Federal Reserve to explore the development of a U.S. Central Bank Digital Currency.

We all understand that this means there will be more guidance, regulations, and interesting reading coming in the next few years.

And Now We Come to the DOL

The DOL issued Compliance Assistance Release No. 2022-01 on March 10, 2022, one day after the Executive Order (someone wanted brownie points!). Much has already been written summarizing the tone of this two-page notice. Overall, the DOL has made it clear that it doesn't believe that cryptocurrency is an appropriate investment to offer in a retirement plan. The many concerns include:

- Cryptocurrency is speculative and volatile;
- It poses challenges for plan participants to make informed investment decisions;
- There are custodial and recordkeeping concerns;
- There are valuation concerns; and
- The regulatory environment is evolving.

These concerns are well-founded, based on the history discussed above. The Release focuses on the concerns related to defined contribution plans. Here at FBLC, we have already begun to see all sorts of administrative challenges with the use of cryptocurrency in 401(k) Plans.

True Life Example: A 401(k) plan was originally operated as an owner-only plan (also known as a Solo (k)). Surprise! There are actually employees in the company who should have been covered, and the Employee Plans Compliance Resolution System ("EPCRS") correction requires that the plan sponsor make a contribution equal to the employees' missed deferral opportunity, *plus earnings*. The owner invested his portion of the plan in cryptocurrency, which resulted in a rate of return several times 100%. How do we calculate the rate of return for the missed deferral opportunity? Is it fair to use the DOL Online Calculator? If not, the cost of correction is going to be very, very expensive for the company.

Cryptocurrency in Defined Benefit Plans – YIKES!

Anyone considering investing in cryptocurrency in a defined benefit ("DB") plan should seriously contemplate this advice: DON'T DO IT. Hugely fluctuating investments in DB plans wreak havoc on funding and can result in a significantly overfunded (or underfunded) plan.

Your best-case scenario, if you don't take this advice, is that cryptocurrency values continue to go up so high that, when you terminate your plan, you will have excess assets. Excess assets that revert back to the employer are subject to income tax plus a 50% excise tax. In addition, if you make huge money on investments, no new contributions will be needed. The reason you set up a DB plan to begin with is probably to shelter significant dollars in a tax-deductible fashion. That's one of the key reasons closely held companies adopt a DB Plan.

Let's flip it around now. Suppose some famous person writes a series of anti-bitcoin Tweets, cryptocurrency prices plummet, losing almost all value, and now the DB Plan is severely underfunded. The plan sponsor may be faced with a large required minimum contribution that it can't fund. That triggers a 10% excise tax. At worst, it could also cause the funding to crash so low that it creates a severe deficiency, causing the Pension Benefit Guaranty Corporation to step in.

If you are unclear on how the investments in a DB plan should be handled, talk to your actuary. They are friendly. Don't be scared.

Conclusion

This is all just the beginning. Whether you are like me (and a number of prominent economists) and believe that these "Tinkerbell" assets are dangerous and shouldn't be in retirement plans, or you believe that it is the future of currency and trading and want to be part of it, know that we are in the infancy stages of this phenomenon. The more that regulatory guidance is issued, the less ambiguity there will be for investors. We welcome both the guidance and future regulations that clarify how cryptocurrency should be treated in retirement plans.

Plan sponsors should be forewarned. Jumping now into the currently unknown universe of cryptocurrency will not be looked upon favorably if the DOL comes for a visit.

Some of these issues will be discussed April 25 – 26 at the Pensions on Peachtree virtual conference, hosted by Ferenczy Benefits Law Center and FIS. We hope you will join us. If you have questions about cryptocurrency – or anything retirement-related – always remember: We are your ERISA solution!

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