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Tax Bills Doom Tax-Free 1031 Exchanges Of Cryptocurrency

Whether you can make a tax-free swap of cryptocurrency is controversial. A 1031 exchange is a swap of one business or investment asset for another. Under the tax code, most swaps are taxable as sales. That's why the IRS says bartering is taxable to both sides, whether for goods or services. Section 1031 is an exception to the rule that swaps are generally fully taxable. If you can manage to come within 1031, you can change the *form* of your investment without (as the IRS sees it) cashing out or recognizing income. But can you swap one cryptocurrency for another, or for other property?

The IRS says cryptocurrency is property not currency, so you might think you could qualify. But whether 1031 applies to cryptocurrency is debatable. Some tax advisers say no, while others offer more positive views, that in some cases 1031 can apply, provided that you are careful. But this debate may not be relevant much longer. Both the House tax bill and the Senate tax bill propose to restrict 1031 exchanges to real estate. The real estate industry is breathing a sigh of relief that 1031 exchanges are being kept for them.

Most exchanges must merely be of “like-kind.” Surprisingly, you can exchange an apartment building for raw land, or a ranch for a strip mall. Classically, an exchange involves a simple swap of one property for another between two people. But the odds of finding someone with the exact property you want who wants the exact property you have are slim. For that reason, the vast majority of exchanges are delayed or “Starker” exchanges (named for the tax case that allowed them). In a delayed exchange, you need a middleman who holds the cash after you “sell” your property and uses it to “buy” the replacement property for you.

This three-party exchange is treated as a swap. The intermediary must meet a number of requirements. That’s one reason delayed exchanges of cryptocurrency may not qualify. There are also two timing rules you must observe in a delayed exchange. Within 45 days of the sale of your property, you must designate replacement property in writing to the intermediary. Then, you must close on the new property within 180 days of the sale of the old.

Until the law changes, what about 1031 exchanges of cryptocurrency? The IRS has been asked about this, but has so far remained mum. A simultaneous Bitcoin for bitcoin swap might be fine. But a Bitcoin for Ripple or Ethereum trade might not qualify. Section 1031 does not apply to trades of stocks or bonds, and the IRS could rely on this to nix any cross-species trade of cryptocurrency. In the past, some gold coin swaps have been OK, while silver for gold is not.
So some observers think the IRS would consider different cryptocurrencies more like silver and gold.

There are also reporting issues. You can’t qualify for 1031 unless you claim it. If you want to see what you have to report to the IRS on your tax return, check out IRS Form 8824. Both the House and Senate tax bills call for restricting Section 1031 to real estate. The two tax bills are filled with controversy, but not over this point. In that sense, the debates over 1031 exchanges of cryptocurrency may not be relevant much longer.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.