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IRS Denies Tax-Free Crypto To Crypto Swaps

The IRS says exchanges of one type of crypto for another are taxable, even if no cash changes hands. However, what about before January 1, 2018, was it tax free? You didn't get cash, so there shouldn't be any income or gain for the IRS to tax, right? If the IRS mines all the crypto data it is getting and audits you, will they allow it? The tax law was changed by statute to say that starting January 1, 2018, crypto trades are taxable. By implication, doesn't that mean they were tax-free in 2017 and before? You might think these questions are no longer relevant, since 2017 is long gone. 2017 tax returns were due on April 15 or October 15 of 2018. The normal three-year statute of limitations should run three years after you file your return. But a six year statute of limitations may apply to many of these situations, giving the IRS until sometime in 2024 to audit.

If you didn't file a return at all, of course, the statute of limitation never runs. The same is true if you file fraudulently. Also, once an IRS audit starts, the IRS routinely asks for extensions of time to audit. Most tax advisers tell you to agree, even if giving the IRS more time seems like giving burglars more time before calling the police. If you don't extend, you usually get hit with a very adverse determination that you have to go to court to try to undo. Thus, the big crypto swap debate is still relevant, and the IRS just confirmed it. On June 18, 2021, the IRS released [Chief Counsel Advise 202124008] to address whether an exchange of (i) Bitcoin for Ether, (ii) Bitcoin for Litecoin, or (iii) Ether for Litecoin qualify as like-kind exchanges under Section [1031] of the tax code. You guessed it, according to the IRS, all three of these swaps—involving no cash—were taxable even before 2018.

It's no secret that the IRS is after crypto in a big way, with warnings, and even a series of John Doe Summonses on exchanges. There's even a question now on Form 1040 tax returns. The big tax law that passed in December 2017 made it clear that that swaps of one crypto for another are not tax free starting in 2018. For prior years, the IRS has been asked about this repeatedly but remained mum until now. Broadly stated, a 1031 exchange is a swap of one business or investment asset for another. Under the tax code, most swaps are taxable, just like a sale for cash. That's one reason the IRS has gone after the barter community to tax goods and services that are exchanged. Section 1031, an exception to the rule that swaps are fully taxable, allows you to change the form of your investment paying taxes.

Your tax basis stays the same, switching from what you gave up to what you acquired. That way, your investment continues to grow tax-deferred. If you qualify, there is no limit on how many times you can do a 1031 exchange. Real estate investors roll over their gain from one investment to another. Despite profits on each swap, they avoid tax until they sell for cash years later, paying only one tax, ideally as a long-term capital gain.

The IRS announced in 2014 that crypto is property for tax purposes. That may have been the shot heard round the crypto world. And while there has been limited crypto tax guidance since then, plenty of big questions remain. Most holders of crypto hold it for investment, but how about the like-kind rule? Swapping silver for gold would be taxable, but different types of crypto are arguably like different types of gold coins. If you could swap of one type of gold coin for another before 2018, why not crypto?

The IRS starts by describing Bitcoin, Ether, and Litecoin. Crypto exchanges allow users to trade one crypto for another, as well as fiat like U.S. dollars. Major crypto like Bitcoin and Ether typically can be traded for any other. However, some can be traded for only a limited number of other crypto and cannot be traded for fiat currency at all. The IRS says that one popular exchange supported more than 30 different cryptocurrencies, but almost all could be acquired with or traded for only Bitcoin, Ether, or fiat. In 2017, there were more than 1,000 different cryptocurrencies in existence. The IRS claims that in 2016 and 2017, most exchanges required Bitcoin or Ether to trade. It was similar on sale, swapping first for Bitcoin or Ether. Because of this, the

IRS says Bitcoin and Ether each differed in nature and character from Litecoin.

Therefore, the IRS concludes that Bitcoin and Litecoin (BTC/LTC) do not qualify as like-kind, nor do Ether and Litecoin (ETH/LTC). The IRS goes on to consider Bitcoin and Ether as against each other. They share similar qualities and uses, the IRS says, but are fundamentally different in design, intended use, and actual use. The IRS says the Bitcoin network is designed to act as a payment network for which Bitcoin acts as the unit of payment. The Ethereum blockchain was intended to act as a payment network and as a platform for operating smart contracts and other applications, with Ether as the fuel, according to the IRS. Ether and Bitcoin are both used to make payments, but the IRS concludes that Bitcoin and Ether are not like-kind property.

There will invariably be questions about other trades, and the IRS does not address them. In fact, the ruling says it *only* covers Bitcoin, Ether, and Litecoin. Besides, even for the ones it covers, this IRS advice (to IRS employees) is not precedential authority. There are still good arguments that pre-2018 swaps were OK, and this is likely not the last word on the subject.

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