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Should You Report Exchanges of Bitcoin?

By Robert W. Wood

You might still think that the biggest tax debate about bitcoin and other cryptocurrency is about whether you should or shouldn't report it. Or perhaps you wonder whether the IRS will catch people who don't. Actually, though, there is not too much debate about those topics these days. Everyone seems to know that you should report, and that the IRS is after crypto taxes and holdouts to reporting in a very serious way.

The IRS is tracking users with software. Moreover, the IRS summons of Coinbase is already bearing fruit with taxpayer account files for the IRS to review. So there's not much to debate on these points. In fact, the biggest crypto tax debate *still* seems to be about 1031, the tax code provision providing for like-kind exchanges.

Everyone knows that 1031 currently only applies to exchanges of real estate. The Trump tax law passed right around Christmas 2017 means that for 2018, you can forget arguing whether swaps of one crypto for another are tax free. They are not tax-free. But it is surprising how much debate there is about the *past*.

If you are about to file your 2017 tax return, should you claim tax-free treatment for past crypto transactions? If you are cleaning up your past tax reporting before the IRS finds you, you might have the same issue for 2016 too, or perhaps even 2015. So, is claiming 1031 treatment for crypto trades for the past smart or stupid? It turns out to be a nuanced subject, which is one reason it is debated.

Until the Trump tax bill killed it, depending on how aggressive you were, and how you could orchestrate it, you could try swapping one digital currency for another. The IRS has been asked about this repeatedly but remained mum. Broadly stated, a 1031 or like-kind exchange is a swap of one business or investment asset for another.

Under the tax code, most swaps are actually taxable, just like a sale for cash. That's one reason the IRS has gone after the barter community, trying to tax goods and services that are exchanged. Section 1031 is an exception to the rule that swaps are fully taxable. 1031 allow you to change the form of your investment without cashing out or 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 or how frequently you can do a 1031. Real estate investors do this all the time, rolling over their gain from one investment to another.

Despite a profit on each swap, they avoid tax until they sell for cash years later, paying only one tax, ideally as a long-term capital gain. Whether 1031 (before 2018) applied to cryptocurrency is debatable. Some exchanges of personal property (say a painting or a private plane) have qualified. But exchanges of corporate stock or partnership interests never did.

Classically, an exchange involves a simple swap of one property for another between two people. But the majority of exchanges are not simultaneous, but 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.

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. Once the sale of your property occurs, the intermediary will receive the cash. Then, within 45 days of the sale of your property, you must designate replacement property in writing to the intermediary, specifying the property you want to acquire.

The second timing rule in a delayed exchange relates to closing. You must close on the new property within 180 days of the sale of the old. These two time periods run concurrently. You start counting when the sale of your property closes. If you designate replacement property exactly 45 days later, you'll have 135 days left to close on the replacement property.

You may have cash left over after the intermediary acquires the replacement property. If so, the intermediary will pay it to you at the end of the 180 days. That cash is called "boot," and is taxed as partial sales proceeds from the sale of your property. You must consider mortgage loans or other debt on the property you relinquish, and any debt on the replacement property. If you don't receive cash back but your liability goes down, that too will be treated like cash.

Many holders of cryptocurrency probably can say they are holding their cryptocurrency for investment. The tougher hurdle is whether they swapped for property of like-kind. Section 1031 does not apply to trades of stocks or bonds, and the IRS could rely on this to disqualify any cross-species trade of cryptocurrency. However, different types of cryptocurrency are arguably like different types of gold coins.

If a swap of one type of gold coin for another qualifies, why not swaps of cryptocurrency? The IRS may argue that swapping Ripple for Bitcoin is really more like swapping silver for gold, or vice versa. Silver for gold would be taxable, so the IRS may say that a swap of cryptocurrency should be taxable too. Some of this may turns on the size of your gains, and how much of a chance are you willing to take.

But one of the biggest issues is about the mechanics of tax reporting. You need to *claim* Section 1031 treatment on your tax return to be able to say that you met the rules. It might seem tempting not to report swaps of cryptocurrency at all. But for those trying to use 1031, failing to report would be a mistake, in my view. If you want to see what to report to the IRS, check out IRS Form 8824.

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