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By **Robert W. Wood**

Biggest Crypto Tax Debate Is Not What You Think

You might think the biggest tax debate about Bitcoin and other cryptocurrencies is about whether you should or shouldn't report it. Or perhaps about whether the US Internal Revenue Service (IRS) will catch people who don't report. Perhaps, but there's not too much debate about those topics these days. Everyone seems to know that you should report, and that the IRS is after taxing cryptocurrencies in a very big way.

The IRS is tracking with software, and the IRS summons of Coinbase is already bearing fruit with files for the IRS to review. In fact, the biggest cryptocurrency tax debate still seems to be about 1031, the tax code provision providing for like-kind exchanges.

Under US tax law, 1031 exchanges can only be of real estate for real estate, starting in 2018. The Trump tax law passed right around Dec. 2017 made it clear that that swaps of one cryptocurrencies for another are not tax free in 2018. But it is surprising how much debate there is about whether this argument can work for 2017 and prior tax years.

If you are about to file your 2017 tax return, should you claim tax-free treatment for past cryptocurrency transactions? If you are cleaning up your past tax reporting before the IRS finds you, you might have the same issue for 2016 too. So, is claiming 1031 treatment for cryptocurrency 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. Donald Trump and other real estate investors can roll 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 applied to cryptocurrency before 2018 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. For many purposes, cryptocurrencies are not stock or securities, but there has often been debate on this point too.

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 - Starker was the name of the man whose tax case made these delayed exchanges famous. 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 is 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 remaining 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.

Robert W. Wood *is a tax lawyer representing clients worldwide from offices at Wood LLP, in San Francisco (www.WoodLLP.com). He is the author of numerous tax books and frequently writes about taxes for Forbes.com, Tax Notes, and other publications. This discussion is not intended as legal advice.*