

## **IRS Denies Tax-Free Treatment for Cryptocurrency Swaps**

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In this article, Wood evaluates the recent IRS chief counsel advice on pre-2018 cryptocurrency exchanges under section 1031.

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If you swapped one kind of cryptocurrency for another before January 1, 2018, was it tax-free? You did not receive cash, so perhaps there should be no income or gain for the IRS to tax? As the IRS mines all the cryptocurrency data it is getting and audits you, will the agency allow tax-free treatment? Section 1031 was changed by statute to say that starting January 1, 2018, cryptocurrency trades are taxable. By implication, doesn't that mean they were tax-free in 2017 and before?

### Big Stakes

You might think these questions are no longer relevant because 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 filing. But there's a six-year statute of limitations that will likely apply to many of these situations. That gives the IRS until sometime in 2024 to audit.

If you didn't file a return at all, the statute of limitations never runs. The same is true if you file fraudulently. But longer limitations periods can

apply more generally too. For example, once an IRS audit starts, the agency routinely asks for extensions of the time to audit. Most tax advisers tell you to agree, even if giving the IRS more time seems like letting a burglar pilfer your house for a while longer before you call the police. If you don't extend the time, you usually get hit with an adverse determination that you have to go to court to try to undo.

Thus, the big cryptocurrency swap debate is still relevant, and the IRS has confirmed it. On June 18 the IRS released ILM 202124008, asking and answering the question: Does an exchange of (1) Bitcoin for Ether, (2) Bitcoin for Litecoin, or (3) Ether for Litecoin qualify as a like-kind exchange under section 1031? You guessed it, the IRS said no, all three of these swaps — involving no cash — were taxable even before 2018.

### Cryptocurrency Mania

It's no secret that the IRS is after cryptocurrency in a big way, with warnings and a series of John Doe summonses served on cryptocurrency exchanges. There's even a cryptocurrency question on Form 1040, "U.S. Individual Income Tax Return." The big tax law that passed in December 2017 made it clear that swaps of one cryptocurrency for another would not be tax-free starting in 2018. The IRS has been asked repeatedly about prior years but has remained mum until now.

Broadly stated, a 1031 or like-kind exchange is a swap of one business or investment asset for another. Classically, an exchange is a simple swap of one property for another. Under the IRC, most swaps are taxable, just like a sale for cash, so the IRS has gone after the barter community to tax goods and services that are exchanged. Of course, cryptocurrency is vastly bigger, and for years it was common to exchange cryptocurrency without going to cash.

Section 1031 is an exception to the rule that swaps are fully taxable, allowing you to change the form of your investment without 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 exchange. Real estate investors routinely roll over their gain from one investment into 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.

### Ruling

The IRS announced in Notice 2014-21, 2014-16 IRB 938, that cryptocurrency is property for tax purposes. That may have been the shot heard 'round the cryptocurrency world. And while there have been limited IRS releases of cryptocurrency tax guidance since then, plenty of big questions remain. Some exchanges of personal property, such as a painting or a plane, clearly qualified as like-kind before 2018. Exchanges of corporate stock or partnership interests never did.

Many if not most holders of cryptocurrency hold it for investment. The tougher hurdle is whether they swapped it for property of like-kind. Swapping silver for gold would be taxable, but different types of cryptocurrencies are arguably like different types of gold coins. If you could swap one type of gold coin for another before 2018, why not cryptocurrency?

### Bitcoin, Ether, Litecoin

In ILM 202124008, the IRS starts by describing Bitcoin, Ether, and Litecoin, as well as exchanges. Cryptocurrency exchanges are digital platforms allowing users to trade one cryptocurrency for another, as well as fiat currency such as U.S. dollars. Popular cryptocurrencies like Bitcoin and Ether typically can be traded for any other, but the IRS says that some types of cryptocurrency can be traded for only a limited number of other cryptocurrencies, and cannot be traded for fiat currency.

The IRS notes that one popular cryptocurrency exchange supported more than 30 different cryptocurrencies, but almost all of them

could be acquired with or traded only for Bitcoin, Ether, or fiat currency. In 2017 there were more than 1,000 different cryptocurrencies in existence, according to the IRS.

Section 1031 says no gain or loss is triggered on an exchange of property held for productive use in a trade or business or for investment if it is exchanged solely for property of like-kind used either for productive use in a trade or business or for investment. Before 2018, section 1031 applied to specific exchanges of personal property. Reg. section 1.1031(a)-1(b) defines like-kind to mean the nature or character of the property and not the grade or quality.

The IRS says that property of one kind or class cannot be exchanged for property of a different kind or class. Therefore, in 1982 the IRS ruled that an exchange of gold for silver was taxable.<sup>1</sup> The IRS even said that a swap of one type of gold coin for another kind of gold coin was taxable. The IRS's reasoning was that one coin's value was derived from its collectibility while the other's value was derived from its metal content.<sup>2</sup>

### Bitcoin/Litecoin and Ether/Litecoin

The IRS says that in 2016 and 2017, Bitcoin and Ether held a special position because most exchanges required Bitcoin or Ether to trade. An individual seeking to buy other cryptocurrencies (say Litecoin) generally had to first buy Bitcoin or Ether. Similarly, an individual seeking to liquidate a cryptocurrency other than Bitcoin or Ether generally had to exchange it for Bitcoin or Ether first. In contrast, Litecoin's trading pair availability at the time was substantially more limited.

Thus, the IRS says that Bitcoin and Ether played a fundamentally different role from other cryptocurrencies during 2016 and 2017. In the IRS's words, Bitcoin and Ether "acted as an on and off-ramp for investments and transactions in other cryptocurrencies." 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 do not qualify as like-kind property, nor do Ether and Litecoin.

<sup>1</sup> Rev. Rul. 82-166, 1982-2 C.B. 190.

<sup>2</sup> Rev. Rul. 79-143, 1979-1 C.B. 264.

## Bitcoin/Ether

The IRS goes on to consider Bitcoin and Ether against each other. They share similar qualities and uses, the IRS says, but are fundamentally different in design, intended use, and actual use. The Bitcoin network is designed to act as a payment network for which Bitcoin acts as the unit of payment.

According to the IRS, 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. Ether and Bitcoin are both used to make payments, but the IRS claims that Ether's additional functionality differentiates it from Bitcoin in nature and character. Therefore, the IRS concludes that Bitcoin and Ether are not like-kind property.

## Other Cryptocurrency Trades

There will invariably be questions about other trades, and the IRS does not address them. In fact, ILM 202124008 states that:

This chief counsel advice is limited to the exchanges involving Bitcoin, Ether, or Litecoin discussed above. This chief counsel advice does not address any other cryptocurrencies, or any other analyses not discussed in this advice. Accordingly, no inferences should be made based on this chief counsel advice that are not explicitly set forth in this advice. . . . This chief counsel advice may not be used or cited as precedent.

Of course, even before you get to other swaps that the IRS does not discuss, there will be big questions about whether this IRS position will prevail if challenged. A chief counsel advice is a legal advisory written to advise IRS personnel. It conveys legal interpretations or positions of the IRS Office of Chief Counsel but is not published in the Internal Revenue Bulletin and is not precedential.

For taxpayers who may face denials of their pre-2018 cryptocurrency swaps and who do not agree with the IRS, historical authorities under section 1031 will be relevant. Some authorities suggest that a liberal test should be used to determine if two types of property are like-kind.

For example, the Fifth Circuit noted in *Crichton* that “the distinction intended and made by the statute is the broad one between classes and characters of property, for instance, between real and personal property.”<sup>3</sup>

However, in Rev. Rul. 79-143, 1979-1 C.B. 264, the IRS ruled that numismatic coins and bullion-type coins were not like-kind.<sup>4</sup> The IRS said numismatic coins may be valued for their condition, age, or beauty in addition to their gold content, while bullion coins are valued based on the price of gold.<sup>5</sup> Similarly, GCM 38899 (Mar. 17, 1982) explained that gold bullion held for investment was not like-kind with silver bullion held for investment.

Arguing that gold and silver are different metals used in different ways, this general counsel memorandum emphasizes that a taxpayer who exchanged gold bullion for silver bullion is not in the same economic position. The memorandum also noted that, as commodities, gold and silver were subject to different market forces. Of course, in announcing in 2014 that all digital currencies will be treated as property for tax purposes, the IRS arguably suggested that it views different digital currencies as essentially similar.

Other authorities suggest that when it comes to property that is intangible,<sup>6</sup> investments do not need to be subject to identical market forces to qualify for like-kind treatment. In TAM 200035005, the IRS noted that “even the narrowest interpretation of the like kind standard *does not require that one property be identical to another or that they be completely interchangeable.*” (Emphasis added.) In this technical memorandum, the IRS concluded that a taxpayer's exchange of Federal Communications Commission radio licenses for

<sup>3</sup> *Crichton v. Commissioner*, 122 F.2d 181, 182 (5th Cir. 1941), *aff'g* 42 B.T.A. 490 (1940).

<sup>4</sup> *But see* Rev. Rul. 76-214, 1976-1 C.B. 218 (Mexican 50-peso gold coins and Austrian 100-corona gold coins are like-kind) *and* Rev. Rul. 82-96, 1982-1 C.B. 113 (gold bullion and Canadian maple leaf gold coins are of like-kind).

<sup>5</sup> *See also California Federal Life Insurance Co. v. Commissioner*, 76 T.C. 107 (1981), *aff'd*, 680 F.2d 85 (9th Cir. 1982) (Swiss francs are not like-kind with U.S. double eagle gold coins, as Swiss francs represent a circulating currency.).

<sup>6</sup> *See* IRS, “Comments on Notice 2014-21: Virtual Currency Guidance” (June 10, 2016) (noting that “virtual currencies are intangible assets because they are represented by a code”).

an FCC television license qualified as a like-kind exchange.

The memorandum says that “the differences in the assigned frequencies are not differences in nature or character, but are merely differences in grade or quality.”<sup>7</sup> Plainly, radio and television licenses may not be subject to identical market forces. In fact, the differences between an FCC radio license and an FCC television license seem much *more* significant than the relatively subtle technical differences between various types of cryptocurrencies.

Authorities concerning other types of assets are helpful too. In Rev. Rul. 67-380, 1967-2 C.B. 291, the IRS held that exchanges of baseball player contracts qualified for like-kind exchange treatment. The IRS also issued informal guidance stating that exchanges of fishing permits are allowed under section 1031, “regardless of whether the permit is for a different fishery, a different species of fish, or a different type of fishing gear.”<sup>8</sup> The regulations provide that a copyright in a novel can be like-kind to a copyright in a different novel.<sup>9</sup>

The IRS even ruled that an exchange of an interest in an improved ranch for an interest in a producing lease of an oil deposit qualified for like-kind treatment.<sup>10</sup> In *Crichton*, the Fifth Circuit approved an exchange of an interest in unimproved country land for an interest in improved city land.<sup>11</sup> Thus, in many cases the IRS and the courts have used the Fifth Circuit’s prescription that section 1031 is designed to exclude only broad distinctions between classes and characters of property, provided that the property is intangible.

### Securities Not Like-Kind

Section 1031 does not apply to “stocks, bonds . . . notes, [or] other securities or evidences of indebtedness or interest.”<sup>12</sup> ILM 202124008 does not suggest that the IRS could view

cryptocurrencies as “other securities” for purposes of section 1031. Presumably, that is because the authorities suggest otherwise.<sup>13</sup> The IRS has stated that Congress’s purpose in adding this exclusion “was to preclude brokers, investment houses, and bond houses from arranging the tax-free exchanges of appreciated securities for their clients.”<sup>14</sup> The IRS has also stated that Congress excluded securities as “essentially like money.”<sup>15</sup>

The IRS has said that call options, put options, and warrants should be treated as securities for purposes of section 1031 because they are “securities for the purposes of a number of different code sections.”<sup>16</sup> The IRS said that puts, warrants, and calls “are usually readily marketable, can be converted, and are ‘essentially like money.’”<sup>17</sup> Moreover, in a series of guidance, the IRS addressed whether whiskey warehouse receipts should be treated as securities for purposes of section 1031.<sup>18</sup>

Whiskey warehouse receipts represent a share in a quantity of whiskey being aged for future sale. They eventually became regulated by the SEC as securities,<sup>19</sup> but the IRS made a preliminary decision not to treat them as securities for purposes of section 1031.<sup>20</sup> The IRS ultimately decided not to publish its proposed ruling “in order to avoid undercutting the SEC.”<sup>21</sup> However, the IRS does not appear to have wavered in its conclusion that these warehouse receipts were not securities for purposes of section 1031.

In any event, the IRS indicated that the term “securities” should be given a fairly limited meaning for purposes of section 1031. The IRS suggested that this meaning was independent of

<sup>7</sup>TAM 200035005.

<sup>8</sup>IRS, “Fishing Audit Technique Guide” (Aug. 2011).

<sup>9</sup>See reg. section 1.1031(a)-2(c)(3), Example 1.

<sup>10</sup>Rev. Rul. 68-331, 1968-1 C.B. 352.

<sup>11</sup>*Crichton*, 122 F.2d 181, *aff’g* B.T.A. 490.

<sup>12</sup>Reg. section 1.1031(a)(1).

<sup>13</sup>GCM 38206 (Dec. 19, 1979).

<sup>14</sup>GCM 35242 (Feb. 16, 1973).

<sup>15</sup>GCM 35918 (Jul. 26, 1974) (citing H.R. Rep. No. 704, 73d Cong., 2d Sess. at 13 (1934)).

<sup>16</sup>GCM 38206 (Dec. 19, 1979).

<sup>17</sup>*Id.*

<sup>18</sup>GCM 32771 (Jan. 20, 1964); GCM 34089 (Apr. 12, 1969); GCM 34500 (May 17, 1971); and GCM 35242.

<sup>19</sup>See, e.g., *Glen-Arden Commodities Inc. v. Costantino*, 493 F.2d 1027, 1035 (2d Cir. 1974).

<sup>20</sup>GCM 32771, GCM 35242, and GCM 34089.

<sup>21</sup>*Id.*

and *narrower* than the definition for SEC purposes.<sup>22</sup>

In recent years, the SEC has taken the position that some cryptocurrencies can be securities for purposes of the securities laws. Enforcement is not unheard of, but there are numerous conflicting views and statements. In any event, regardless of what the SEC says, it is more relevant whether cryptocurrencies are treated as securities in some other provisions of the IRC. There appears to be no such suggestion. The IRS has stood firmly by its 2014 decision that cryptocurrency is property for tax purposes, and the recent chief counsel advice stays with that theme.

### 1031 Reporting

One might assume that you must claim section 1031 treatment on your tax return to be able to say that you met the rules. The IRS

indicates what to report on Form 8824, "Like-Kind Exchanges," and it is commonly used. However, the IRS has also said that if a transaction qualifies as a like-kind exchange under section 1031, then the deferral of gain is mandatory, regardless of whether the taxpayer actually reports the transaction as a section 1031 exchange on his return.<sup>23</sup> That should be comforting to some cryptocurrency investors whose reporting may have been less than pristine.

### Conclusion

The IRS has taken a shot across the bow with the chief counsel advice in ILM 202124008, but it is unlikely to be the last word. Although there are certainly some tax returns from before 2018 that are still fair game, this also may not be an issue that the IRS will decide to push. ■

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<sup>22</sup>GCM 32771.

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<sup>23</sup>See TAM 201437012.