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Loophole Allows Tax-Free Bitcoin Exchanges Into 2018

After December 31, 2017, it is clear that only real estate can be the subject of a tax-free 1031 exchange. A 1031 exchange is a swap of one like kind business or investment asset for another. The IRS treats most swaps are taxable as sales, so 1031 is an exception to the normal rule. The IRS says cryptocurrency is property not currency. So, many investors assumed that meant you could swap them tax-free under section 1031. But whether 1031 applied to cryptocurrency until year end is debatable. Some tax advisers say no, while others yes, provided that you did it all carefully.

That 'carefully' part turned out to be important. Some crypto investors bought and sold without trying to improve the "exchange" optics. Whichever side of this debate you are on, the massive tax bill that was just passed limits 1031 exchanges to real estate. Yet even that new tax law is having a curious impact among crypto investors, who want to keep debating. Sure, the law now says 1031 is only for real estate. But does that change in the law strengthen or weaken the argument that 1031 can apply to crypto deals done in say 2016 or 2017?

Some say the fact that Congress changed the law (prospectively) makes it clear that before the change in the law, crypto swaps were OK. Others say the reverse. It is not clear what the IRS will say. What's more, there are at least some indications that there's a last ditch effort to do crypto deals before the end of 2017, including some that might be extended into 2018. The new law (saying 1031 is only for real estate) goes into effect for deals after December 31, 2017.

However, the law says that, "[A]n exception is provided for any exchange if the property disposed of by the taxpayer in the exchange is disposed of on or before December 31, 2017, or the property received by the taxpayer in the exchange is received on or before such date." What this means is that (if 1031 does apply to crypto swaps), it still does through the end of 2017. But is that enough time? For a direct two party swap, it may be. And what about extending into 2018? It might go something like this.

Suppose that you want to trade Bitcoin for Ethereum. Assume that your tax adviser is convinced that such a cross-species swap is OK under 1031, until the end of 2017. But, instead of selling your Bitcoin, say you buy the Ethereum first, though a qualified intermediary. Once you do that, you could have up to 45 days to designate the property the intermediary will acquire for you. Then after that, you should have another 135 days (for a total of up to 180 days from your original purchase transaction) to actually have your intermediary get the other leg of the "exchange" closed.

You could call this a reverse exchange, because it involves buying before selling. Assuming that 1031 applies to a direct Bitcoin for (say) Ethereum swap, this kind of year-end reverse exchange arguably should too. Of course, you would still want to observe the formalities, actually have an intermediary, and actually have documents (such as an 'exchange agreement') that spells out all the particulars.

When it comes right down to it, one reason many investors might fail to meet 1031's requirements may not be that their deal involved crypto, but rather that they just sold their crypto (taxable), and bought something else. If you were doing that with real estate, that would not work either. One can always make arguments, of course. But if you are arguing for 1031 treatment, you might expect the IRS to focus on documents, mechanics, and reporting. Meanwhile, crypto investors are already searching for other ways to try to diversify without paying all the taxes.

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