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House and Senate Tax Bills Kill Cryptocurrency “Like Kind” Exchanges: Expert Blog

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Broadly stated, a 1031 exchange (also called a like-kind exchange or a Starker) is a swap of one business or investment asset for another. Under US tax code, most swaps are taxable as sales. In fact, the IRS has actively 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 generally fully taxable. If you can manage to come within 1031, you'll either have no tax, or limited tax due at the time of the exchange. In effect, you can change the form of your investment without (as the IRS sees it) cashing out or recognizing a capital gain. That way your investment continues to grow, tax-deferred. If you qualify, there's no limit on how many times or how frequently you can do a 1031.

Primarily used for real estate

Big commercial real estate developers do this all the time. Think Donald Trump.

You can roll over the gain from one piece of investment real estate to another, to another and another. Although you may have a profit on each swap, you avoid tax until you actually sell for cash many years later. Then, you'll hopefully pay only one tax, at a long-term capital gains rate.

Since the IRS says cryptocurrency is property and not currency, swaps under 1031 should be fine, right? Not so fast - whether 1031 applies to cryptocurrency is debatable. But the debate may not be relevant for much longer, since both the House tax bill and the Senate tax bill propose to restrict 1031 exchanges to real estate only.

The real estate industry is breathing a big sigh of relief that 1031 exchanges are being kept for them. In fact, the vast majority of 1031 exchanges are of real estate. However, some exchanges of personal property (say a painting) can qualify. But exchanges of corporate stock or partnership interests don't qualify. On the other hand, interests as a tenant in common (sometimes called TICs) in real estate do.

Most exchanges must merely be of "like-kind"—an enigmatic phrase that doesn't mean what you think it means. You can exchange an apartment building for raw land, or a ranch for a strip mall. Classically, an exchange involves a simple swap of one property for another between two people.

Delayed exchanges

But the odds of finding someone with the exact property you want who wants the exact property you have are slim. For that reason, the vast majority of exchanges 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 for you.

This three-party exchange is treated as a swap. 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. Note that the two time periods run concurrently. That means 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–known as "boot"—will be 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 just like cash. There are many traps that can derail tax-free treatment.

What about cryptocurrency?

Until the law changes, what about 1031 exchanges of cryptocurrency? The IRS has been asked about this, but has so far remained mum. Some holders of cryptocurrency probably can say they are holding their cryptocurrency for use in their business or for investment. In fact, the investment use qualifier seems easy.

But the far tougher hurdle is whether they are swapping for property of like-kind. A direct Bitcoin for Bitcoin swap might be fine. But a Bitcoin for Ripple or Ethereum trade might not qualify. Section 1031 does not apply to trades of stocks or bonds, and the IRS could rely on this to nix any cross-species trade of cryptocurrency.

On the other hand, one might argue that different types of cryptocurrency are a little like different types of gold coins. If a swap of one type of gold coin for another qualifies, why not swaps of cryptocurrency? However, one likely IRS answer might be that if you swap, say, Ripple for Bitcoin, that is really more like swapping silver for gold, or vice versa.

Silver for gold would be taxable, so the IRS may say that a cross-species swap of cryptocurrency should be too. Many observers think this is how the IRS would come out. But the IRS hasn't said this so far. So, some of this question turns on risk.

On risk and reporting

How big are the gains you are hoping to shield, and how much of a chance are you willing to take? On top of those questions, there are tax reporting rules to address. 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 and try to fly under the radar. But for those trying to use 1031, failing to report would be a mistake, in my view. You can't qualify for 1031 unless you claim it. If you want to see what you have to report to the IRS on your tax return, check out IRS Form 8824.

Both the House and Senate tax bills call for cutting back Section 1031 to cover only real estate. The two tax bills are filled with controversy, but not over this point. In that sense, the debates over 1031 exchanges of cryptocurrency may not be relevant too much longer.

***Bio: 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 writes frequently about taxes for Forbes.com, Tax Notes, and other publications.*