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IRS Says No Tax-Free Exchange Treatment for Swaps of Bitcoin, Ether, and Litecoin

The IRS has published guidance stating that pre-2018 swaps among Bitcoin, Ether, and Litecoin are not eligible for 1031 tax-free exchange treatment. This means that investors who made swaps among these three cryptocurrencies before 2018 are liable for income tax on the gains realized. This guidance only applies to swaps before 2018, because the Tax Cuts and Jobs Act of 2017 eliminated § 1031 tax-free exchange treatment for personal property beginning after 2017, so that *all* cryptocurrency exchanges beginning in 2018 would be subject to income tax.

The guidance ([General Counsel Memorandum 202124008](#)) reasons that pre-2018 exchanges between Bitcoin and Litecoin or between Ether and Litecoin were not exchanges of like-kind property – and are therefore taxable – because both Bitcoin and Ether had a special role in cryptocurrency trading since investors wanting to trade in other cryptocurrencies had to exchange the other currencies into or from either Bitcoin or Ether. This special role shared by Bitcoin and Ether made them different from Litecoin (and likely most other cryptocurrencies), and therefore exchanges between Litecoin and either Bitcoin or Ether were not like-kind exchanges under section 1031.

The memorandum further concludes that pre-2018 exchanges between Bitcoin and Ether were likewise taxable because of their differences in overall design, intended use, and actual use. The memorandum states that Bitcoin is designed to act as a payment network, with Bitcoin acting as the unit of payment. On the other hand, according to the memo, the Ethereum blockchain was intended to act as a payment network and to act as a platform for operating smart contracts and other applications, with Ether working

as the “fuel” for these features. As a result, the memorandum concludes that Bitcoin and Ether are not like-kind property, and not eligible for § 1031 tax-free exchange treatment.

The guidance states that it only applies to exchanges among Bitcoin, Ether, and Litecoin, but it is quite possible that the IRS would extend this rationale to other cryptocurrencies that share characteristics with these three cryptocurrencies. Furthermore, while the guidance only applies to pre-2018 cryptocurrency swaps, it is a stark reminder to present-day investors that every exchange of cryptocurrencies is now a taxable event, since 1031 tax-free exchange treatment has not been available for personal property since Jan. 1, 2018.

Investors who were swapping these cryptocurrencies before 2018 and assuming these trades were tax-free § 1031 exchanges might be in for a rude awakening. It is not clear why it took the IRS so long to come out with guidance on whether cryptocurrency swaps were or were not entitled to tax-free exchange treatment – this guidance comes seven years after [the initial IRS announcement](#) that cryptocurrency should be treated as property, and not as a currency for income-tax purposes. Nevertheless, many investors are now exposed to back taxes, interest, and penalties for not reporting their gains on pre-2018 swaps. The general statute of limitations is three years from the date the tax return was filed, so that the statute of limitations for the IRS to audit would have expired for the 2017 and prior tax years if a 2017 return was filed by April 15, 2018 (but 2017 might still be an open year if the return was filed on extension). However, there is a special six-year statute of limitations in cases where the taxpayer failed to report more than 25% of their income. Accordingly, the statute of limitations for investors who recognized substantial gains from trading cryptocurrencies might be open for years going as far back as the 2015 tax year (or even 2014 if they filed on extension). Businesses with potential exposure should consult with experienced tax counsel. Furthermore, if the IRS alleges that the failure to report cryptocurrency transactions was fraudulent, the statute of limitations to assess back taxes would run without any time limit.

Investors who exchanged cryptocurrencies prior to 2018 should consult their tax advisor to determine if the six-year statute of limitations might still be open, and if so, consider filing amended returns to report their gains. The IRS has obtained and [is in the process of obtaining](#) trading information from cryptocurrency exchanges, so the government may already or soon will know the extent of crypto swaps made by investors.

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