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Internal Revenue Service
Memorandum

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subject: Applicability of Section 1031 to Exchanges of Bitcoin (BTC) for Ether (ETH), Bitcoin for Litecoin (LTC), and Ether for Litecoin

This responds to your request for non-taxpayer specific advice regarding the applicability of § 1031 of the Internal Revenue Code ("Code") to exchanges of certain cryptocurrencies completed prior to January 1, 2018.

ISSUE

If completed prior to January 1, 2018, does an exchange of (i) Bitcoin for Ether, (ii) Bitcoin for Litecoin, or (iii) Ether for Litecoin qualify as a like-kind exchange under § 1031 of the Code?

CONCLUSION

No. If completed prior to January 1, 2018, an exchange of (i) Bitcoin for Ether, (ii) Bitcoin for Litecoin, or (iii) Ether for Litecoin does not qualify as a like-kind exchange under § 1031 of the Code.

BACKGROUND

Virtual currency is a digital representation of value that functions as a medium of exchange, a unit of account, or a store of value other than a representation of the U.S. dollar or a foreign currency. Notice 2014-21; Rev. Rul. 2019-24. Virtual currency that has an equivalent value in real currency, or acts as a substitute for real currency, such as Bitcoin, is referred to as “convertible” virtual currency and is considered property for federal income tax purposes. Notice 2014-21. Accordingly, general tax principles applicable to property transactions apply to transactions involving convertible virtual currency. Id.

Bitcoin, Ether, and Litecoin are all forms of cryptocurrency, a type of virtual currency that utilizes cryptography to secure transactions that are digitally recorded on a distributed ledger, such as a blockchain. Rev. Rul. 2019-24 at 2. Distributed ledger technology uses independent digital systems to record, share, and synchronize transactions, the details of which are recorded in multiple places at the same time with no central data store or administration functionality. Id. Cryptocurrencies may be used as a method of payment; however, many taxpayers transact in cryptocurrency for investment or other purposes.

Cryptocurrency exchanges are digital platforms that allow users to trade one cryptocurrency for another cryptocurrency, as well as for fiat currencies such as the U.S. dollar. The possible combinations supported by the exchange are known as trading pairs. Major cryptocurrencies like Bitcoin and Ether typically may be traded for any other cryptocurrency and vice versa. However, some cryptocurrencies on a cryptocurrency exchange can be traded for only a limited number of other cryptocurrencies and cannot be traded for fiat currency at all. For example, one popular cryptocurrency exchange supported more than 30 different cryptocurrencies, but almost all of them could be acquired with or traded for only Bitcoin, Ether, or fiat currency. In 2017, there were more than 1,000 different cryptocurrencies in existence.

DISCUSSION

Section 1031(a)(1) of the Code provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment. The nonrecognition of gain or loss under § 1031 is intended to apply to transactions where the taxpayer's economic situation following the exchange is essentially the same as it had been before the transaction. H. Rept. 704, 73d Cong., 2d Sess. (1934), 1939-1 C.B. (Part 2) 554, 564. The Tax Cuts and Jobs Act, P.L. 115-97, amended § 1031 to limit like-kind exchange treatment after December 31, 2017, to exchanges of real property. Prior to 2018, section 1031 also applied to certain exchanges of personal property.

Treas. Reg. § 1.1031(a)-1(b) defines “like kind” to mean the nature or character of the property and not the grade or quality. One kind or class of property may not be exchanged for property of a different kind or class. For example, an investor who exchanged gold bullion for silver bullion was required to recognize gain in part because silver is primarily used as an industrial commodity while gold is primarily used as an investment. Rev. Rul. 82-166. Similarly, an investor who exchanged one kind of gold coin for another kind of gold coin was required to recognize a gain because one coin’s value was derived from its collectability while the other's value was derived from its metal content. Rev. Rul. 79-143.

BTC/LTC and ETH/LTC

In 2016 and 2017, Bitcoin, and to a lesser extent Ether, held a special position within the cryptocurrency market because the vast majority of cryptocurrency-to-fiat trading pairs offered by cryptocurrency exchanges had either Bitcoin or Ether as part of the pair. In other words, an individual seeking to invest in a cryptocurrency other than Bitcoin or Ether, such as Litecoin, would generally need to acquire either Bitcoin or Ether first. Similarly, an individual seeking to liquidate his or her holdings in a cryptocurrency other than Bitcoin or Ether, such as Litecoin, generally would need to exchange those holdings for Bitcoin or Ether first. In contrast, Litecoin's trading pair availability at the time was substantially more limited.

Thus, Bitcoin and Ether played a fundamentally different role from other cryptocurrencies within the broader cryptocurrency market during 2016 and 2017. Unlike other cryptocurrencies, Bitcoin and Ether acted as an on and off-ramp for investments and transactions in other cryptocurrencies. Because of this difference, Bitcoin and Ether each differed in both nature and character from Litecoin. Therefore, Bitcoin and Litecoin (BTC/LTC) do not qualify as like-kind property for purposes of section 1031; nor do Ether and Litecoin (ETH/LTC).

BTC/ETH

As discussed above, Bitcoin and Ether shared a special role in the cryptocurrency market that made them fundamentally different from Litecoin during the relevant years. However, while both cryptocurrencies share similar qualities and uses, they are also fundamentally different from each other because of the difference in overall 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. The Ethereum blockchain, on the other hand, was intended to act as a payment network and as a platform for operating smart contracts and other applications, with Ether working as the "fuel" for these features. Thus, although Ether and Bitcoin may both be used to make payments, Ether's additional functionality differentiates Ether from Bitcoin in both nature and character. Therefore, Bitcoin and Ether do not qualify as like-kind property under section 1031.

CONCLUSION

If completed prior to January 1, 2018, an exchange of (i) Bitcoin for Ether, (ii) Bitcoin for Litecoin, or (iii) Ether for Litecoin does not qualify as a like-kind exchange under § 1031.

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.

Please contact James Yu at (202) 317-4718 if you have any further questions.