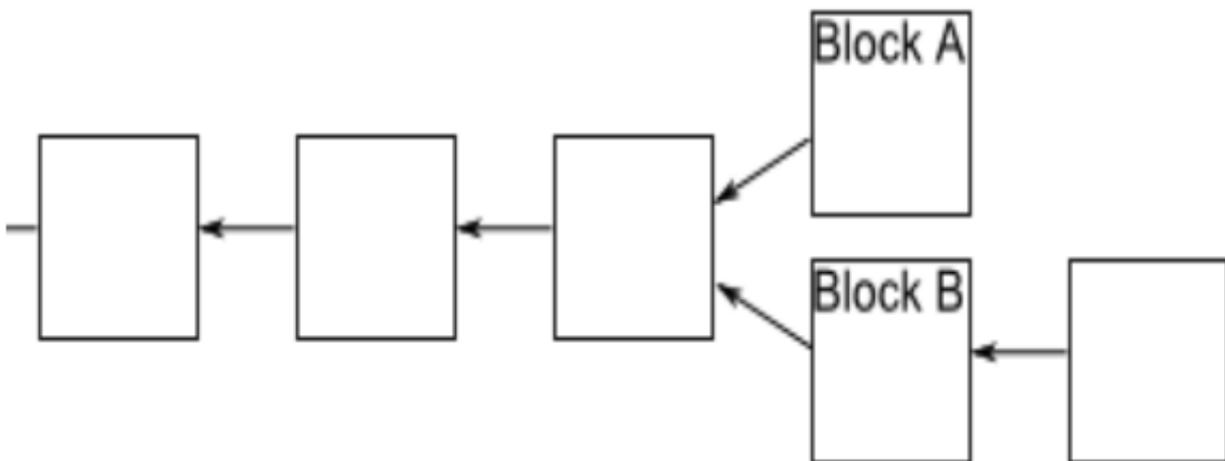

Taxation of Forks

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One of the brilliant aspects of bitcoin is its solution to the “double spend” problem. In practical terms, the double spend problem is the possibility that digital currency, since it is just code, unlike coins, script or centrally controlled fiat currency, can be copied and used or spent more than once. Technically, the way this double spend happens is via a “fork” in the blockchain. In other words, the digital coin is spent twice by adding a second block, illustrated:



How Satoshi solves this problem is the same way that fish school, birds flock and giraffes evolve: the longest chain wins. When there is a “fork”, the community accepts the chain with the greatest computational power, or the longest chain. In the example above, the Block B chain is longer than Block A, so that would be deemed the first spend of the “coin” and the Block A chain would be invalidated.

Sometimes, however, the community intends to split the chain and treat both chains as valid. Most famously, bitcoin spun off bitcoin cash (BCH) in August 2017 to allow for faster coins (Bitcoin is slow). If you held bitcoin in your wallet in August of 2017, you may have noticed that your balance magically increased by the value of these new freshly minted (or chain split) coins. BCH results from a hard fork because BCH is a whole new chain that will operate independently of the original fork. Your first thought might have been “yay, free money.” Your second thought should have been “I wonder if I am taxable on this.”

Even Satoshi’s brilliance could not have advised you on the second question, as the taxation of BCH is unclear. Even Einstein called tax law impossibly complicated, and this is an example of why.

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Since there is no direct authority, tax lawyers immediately went off in search of analogies, none

of which are perfect. We are guided first by the broad pronouncement in *Commissioner v. Glenshaw Glass* that gross income includes instances of undeniable accessions to wealth, clearly realized, over which the taxpayers have total dominion. That's a lot to unpack, so let's start with the "accession to wealth" part. In its simplest form, we started with just BTC, worth \$x, and after the fork had BTC and BCH, worth something more than \$x. It would be hard to argue that we have not had an accession to wealth. Is there an exception to this general rule?

For example, at first blush a fork seems a lot like a stock dividend, which we all learned in law school is nontaxable under *Eisner v. Macomber* because it represents no new succession to wealth. Instead, a stock dividend just represented more shares for the same value. The key difference here is that we are not splitting up the same pie as in *Eisner v. Macomber*, we are creating a brand new pie. This is a lot like having an apple tree that produces apples. The apples, too, are accessions to wealth, but I think we would all be surprised if one day we looked outside our windows and discovered a revenue agent busily counting apples, preparing to assess us for additional income. Some other nontaxable examples are calved cattle from cows, extracted minerals from the ground or cut timber from land. Conversely, taxable analogies include awards, some frequent flyer miles, and found treasure.

Another view is to focus on the "dominion and control" aspect of *Eisner v. Macomber*, and analogize to authorities where taxpayers have received property, but have not accepted it, and were not taxed unless they did. As an example, book reviewers receive free books, that they may or may not read. They are not taxed on books they do not read. Honestly, that feels wrong since the nature of BCH, for example, is that it *could* be converted to cash, and the consequence of not converting is that the taxpayer is making a new investment.

We can point to analogous authorities to support many views, and come to no firm, authoritative conclusions.

Blockchain is a new, revolutionary and important technology. As the internet digitized information, blockchain can be said to have digitized assets. That is a radical change in the way commerce is done and one that does not easily fit into existing tax rules. Congress has recognized the issue and has asked the IRS to come up with rules to address crypto currency transactions. The ABA Taxation Section has proposed a taxpayer favorable safe harbor rule on this exact issue that would treat the fork as a realization event, but value the forked coins at zero.

As of this writing, we do not have firm guidance on the treatment of forks. That will leave millions of Americans wondering how to report forks on their tax returns, if at all. There seem to be a few options: (1) pay the man, (2) hide in the weeds or (3) flag the issue on the return.

My guess is that human nature will lead few taxpayers to "pay the man" and voluntarily pay tax on the value of their forked coins. Most taxpayers will simply hide in the weeds, and hope that the IRS does not notice them or that they will adopt taxpayer favorable guidance that will apply retroactively. If that works, great. If, however, it doesn't work, the taxpayer may have to face the possibility of additional taxes, interest and penalties.

Penalties can be severe for undisclosed positions taken without substantial authority. IRC section 6662(b). "Substantial authority" is an objective standard, could be less than "more likely than not" (more than 50%) but must be more than "reasonable basis" (more than merely

arguable). The weight of authorities supporting the tax treatment of an item must be substantial in relation to the authorities supporting contrary positions, in light of the pertinent facts and circumstances. As noted, there is no direct authority of hard forks. In that sort or case, substantial authority can be a well-reasoned construction of the statute.

Tax advisors will be asked to determine whether there is a well-reasoned construction of the Internal Revenue Code that supports excluding hard forks from income.

The tax preparers themselves may have penalty exposure for unrealistic positions unless there is adequate disclosure and reasonable cause for the understatement by a preparer who acted in good faith. IRC Section 6694(a). A position is unrealistic if it has no realistic possibility of being sustained on the merits, that is, if a person knowledgeable in the tax law would conclude, based on a reasonable and well-informed analysis, that the position does not have at the least approximately a one-in-three chance of being sustained on its merits.

So what should taxpayers do while we await IRS guidance? The answer is:

It depends.

Since we have no specific guidance, the answer might depend on the taxpayer's (and his or her preparer's) risk tolerance level. Some relevant questions might be: How much is at stake? Did the taxpayer try to exercise control over the forked coins? Did the value of the original coins decrease because of the fork (similar to a stock dividend) and can we attribute that to a split in value? Importantly, affected taxpayers should seek guidance on this issue and monitor developments.