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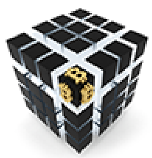

SPLITCOIN: The Impact of the World’s Biggest Cryptocurrency Forking Into Two.

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On August 1, 2017, Bitcoin, the world’s most capitalized and popular digital currency, was split into two separate blockchains, “Bitcoin”[classic] and “Bitcoin Cash.” The controversial decision to “Hard Fork” Bitcoin’s code arose out of a recent debate as how to best increase the transaction speed of the digital currency network. As use of Bitcoin has greatly increased over the past several years, the clearing and settlement of transactions, which are handled by independent computer “miners” on the system, has decreased to the point where many question Bitcoin’s ability to persistently compete against the traditional payment and card systems – which has arguably been the most successful use of the technology. Moreover, Bitcoin is increasingly faced with competition from other emerging cryptocurrencies including Ether (which also forked recently into two separate codes) and Litecoin, which continue to gain ground in the market. To facilitate more efficient processing, Bitcoin users are currently able to pay a transaction fee to incentivize the miners to give their transactions a higher priority in the settlement hierarchy. However, it can take up to several hours for the entire blockchain to run, leaving some in the industry to wonder about the continuation of this slowing-down trend. Some would-be users even question whether Bitcoin’s existing structure will continue to support its underlying mission to promote seamless, low-cost financial transactions for all.

Unlike the “Hard Fork” that arose from security concerns during the capital raise of “The DAO” in July 2016 the Bitcoin split was the result of a difference in opinion, between the Bitcoin open-source code community and the network miners, as to how to best restructure the code to quicken the transactions. Bitcoin [classic] adopted a method called “SegWit2x”, which moved part of the transaction information out of the blockchain itself, where Bitcoin Cash created bigger blocks of data within the blockchain. The former is favored by the Bitcoin miners. Under both Bitcoin models, the speed of a given transaction is largely dependent upon the number of miners assisting with validating transactions. The more miners supporting a particular platform means faster processing. With the miners in greater support for Bitcoin [classic], there is immediate concern that Bitcoin Cash might not have sufficient processing support from their miners to efficiently run transactions in its separate currency. Bitcoin Cash also has additional concerns including that some Bitcoin exchanges have not yet adopted Bitcoin Cash, and many in the industry question the long-term success of both digital currencies in tandem. As a result, the valuation of both digital currencies have experienced immediate market volatility.

The split will likely incur additional scrutiny from regulatory agencies in the U.S. and abroad, as well as implicate securities regulations because the two new currencies could potentially be considered the issuance of new digital currencies. (*See* SEC: Digital Coin, Blockchain Capital Raises are Subject to Securities Laws). Further, there will likely be disputes arising from the inconsistent manner in which Bitcoin service providers have managed the split. The majority of exchanges and digital wallets, which function similar to a bank account, seem to have converted, or will convert, Bitcoin holdings by users to 50% Bitcoin [classic] and 50% Bitcoin Cash. However, not all financial service providers are taking this approach.

As future valuations of the two digital currencies diverge, there is the potential for user complaints and litigations to arise in response to the alternative methods of handling this Hard Fork by these Bitcoin service providers – especially if users allege some sort of fiduciary duty is owed them by their Bitcoin exchanges and wallets.

The digital currency space also anxiously awaits the reaction by the IRS with respect to the split, which resulted in a nominal doubling of digital currency held by many Bitcoin users. In 2014, the IRS issued a notice where it signaled that it would consider Bitcoin mining as general income and appreciation of the currency as a capital gain. If the IRS takes the position that the Bitcoin split was akin to a stock split, then little if any tax considerations need to be considered at this time. However, if the IRS decides that the new digital coins are a new issuance, then the implications of the 2014 Notice may be applied in a way that results in increased tax burdens on Bitcoin users.

For more information on the matters discussed in this *Locke Lord QuickStudy*, please contact the authors.

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