
Vellum
Weekly
CRYPTOCURRENCY IN KENYA

Introduction

With the collapse of Futures Exchange (FTX), a global cryptocurrency exchange where big firms and individuals had invested a lot of money in, questions have arisen about the safety of investing in the currency. Over four million Kenyans are said to own cryptocurrencies, ranking Kenya fifth in terms of cryptocurrency activity globally and interest in the currency from Kenyans is at an all-time high according to data from online searches.

This article looks at the pros and cons of investing in cryptocurrencies and what investors need to be aware of in order to avoid losing money trading in the largely new and as yet unclear field of digital currency.

What is a Cryptocurrency?

A cryptocurrency is a digital currency and an alternative form of payment created by the use of encryption algorithms. An encryption algorithm is a method used to transform data into ciphertext. This algorithm uses the encryption key in order to transform the data in a predictable way, so that even though the encrypted data will appear random, it can be turned back into plaintext by using the decryption key.

The use of encryption technologies means that cryptocurrencies function both as a currency and as a virtual accounting system. To use cryptocurrencies, one needs a cryptocurrency wallet which is a piece of software hosted on a cloud-based service and stored on your computer or on your mobile device to store your encryption keys that confirm your identity and link to your cryptocurrency. Cryptocurrencies are not considered a currency but rather a commodity, like Gold, or a security though this is still a subject of debate right now.

Cryptocurrency uses

Money transfers

Sending and accepting payments at low cost and high speed is one of the most well-known applications of cryptocurrency that almost everyone is familiar with. Increased interest has been shown by retail banking clients, fintech, venture capital funds, and institutional investors in this financial vehicle and distributed ledger technology.

This is because the cryptocurrency payment system is Peer-to-Peer (P2P), meaning users can instantly send and receive payments globally without requiring approval from any external source. Moreover, there is no banking fee, no overdraft charges, no returned deposit fees, etc as in other financial institutions.

Online transactions

Cryptocurrencies are used for buying and selling goods and services online which means that there is no coin or bill used since all the transactions take place online. An online ledger with strong cryptography is used to ensure that online transactions are completely secure. Several businesses and enterprises worldwide, for instance hotels, restaurants, flights, jewelers, and applications have embraced it as a viable payment medium.

One of the most notable acceptors of cryptocurrency as a viable medium of payment is Apple Inc. It allows 10 types of cryptocurrencies for carrying out transactions on the App Store.

There are cryptocurrencies firms where people tend to benefit from the transactions, especially if they are the ones facilitating the transactions. This is different from banks or other financial institutions.

Investments / Store of value

Millions of people have embraced cryptocurrency as a mode of investing. Reports indicate that Bitcoin is one of the most lucrative investment options currently present.

Its value appreciation is supremely dynamic and can provet o be an excellent avenue for capital expansion.

Security in the blockchain Technology

Cryptocurrencies are thought to be fairly safe due to the encryption that is used. Your data is kept in a safe wallet which has an encryption key which only the owner has access to diminishing the probability of theft.

Many cryptocurrencies exist but for the purposes of this paper we will discuss five types of cryptocurrencies.

Bitcoin

Since its creation in 2009, Bitcoin has become a revolutionary digital currency.

Because it enables peer-to-peer payments without a third party (like a bank), it has set off a tidal wave of other cryptocurrencies and digital assets making use of blockchain technology.

Ethereum

Ether is the token used to facilitate transactions on the Ethereum network.

Ethereum is a platform that uses blockchain technology to enable the creation of smart contracts and other decentralized applications *(meaning the software doesn't have to be distributed on app exchanges like Apple's App Store or Alphabet's Google Play Store, where they might have to give a 30% cut of any revenue earned to the tech giants).*

Ethereum is both a cryptocurrency *(the actual coins are measured in units called Ether)* and a software development sandbox.

Tether

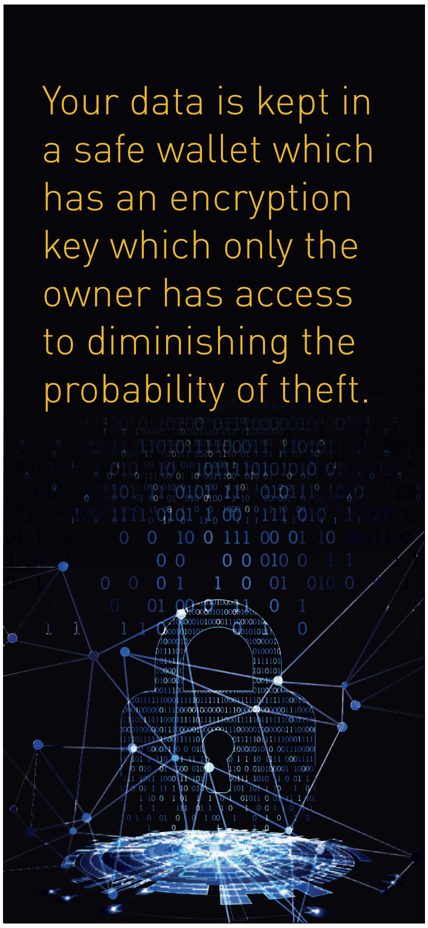
Tether is a stable coin, or a currency tied to a fiat currency - in this case, the U.S. dollar.

The idea behind Tether is to combine the benefits of a cryptocurrency (such as no need for financial intermediaries) with the stability of a currency issued by a sovereign government *(as opposed to the wild price fluctuations inherent with many cryptos).*

Binance Coin

The Binance Coin is available on the Binance cryptocurrency exchange platform, along with other digital coins that are available for trading.

Binance Coin can be used as a type of currency, but it also facilitates tokens that can be used to pay fees on the Binance exchange and to power Binance's DEX (decentralized exchange) for building apps.



USD Coin

USD Coin is another stablecoin, and, like Tether, it is pegged to the U.S. dollar. Also like Tether, USD Coin is hosted on the Ethereum blockchain.

The idea behind USD Coin was to create a "fully digital" dollar, one that has the stability of U.S. fiat currency but doesn't require a bank account or that the holder live in a particular country. Rather than an investment, USD Coin is envisioned as everyday money that can be spent with merchants on the internet.

Laws governing cryptocurrency

As earlier stated, cryptocurrencies use peer to peer mechanisms evading oversight and regulation in countries. The main financial regulatory bodies for fiat currency are the Central Bank of Kenya (CBK), the Capital Markets Authority and the Kenya Revenue Authority.

So far, the CBK has made statements refusing to acknowledge cryptocurrencies as legal tender in Kenya. At the same time, the CBK has been sending mixed signals by showing a willingness to have its own digital currency.

The president has also declared the intent to have cryptocurrency taxed. This could be attributed to the fact that there is no specific law in the country to tame such an elusive asset. It is therefore important to look at the oversight institutions in the country and impending bills that might be introduced on cryptocurrency in the country.

Central Bank of Kenya (CBK)

The Central Bank of Kenya is responsible for formulating monetary policy to achieve and maintain price stability. The Central Bank also promotes financial stability; an effective and efficient payment, clearing and settlement system; formulates and implements foreign exchange policies; holds and manages foreign exchange reserves; issuing of currency; and is the banker for, adviser to and fiscal agent of the Government.

CBK is also authorised to regulate cryptocurrencies through Kenya's Money Remittance regulations. Under these regulations, cryptocurrency companies must acquire licensing from Kenyan authorities to offer transmission services within Kenya. Licensing is required whenever a company offers a service for the transmission of money or any representation of monetary value without any payment accounts being created in the name of the payer or the payee, including: where funds are received from a payer for the sole purpose of transferring a corresponding amount to a payee or another payment service operator acting on behalf of the payee; or where funds are received on behalf of and made available to the payee. Cryptocurrency companies that do not acquire the proper authorization from Kenyan authorities will have their banking services suspended.

There is currently a proposal for the country to issue its own coin with the CBK issuing a paper for discussion on the establishment of a Central Bank Digital Currency. If implemented, Kenya could be the second African nation to implement it after Nigeria. Kenya has also indicated its interest in switch to bitcoin as a reserve currency. One can see that there is some confusion in Kenya on the regulator's intent with regard to crypto. The Central Bank seems to be sending mixed signals as to their approach to crypto, on the one hand refusing to accept it as legal tender and on the other hand seemingly adopting it even for national interests and transactions.

Capital Markets Authority (CMA)

The Capital Markets Authority is an independent public agency established by an Act of Parliament, Cap 485 A under The National Treasury. The CMA is a regulatory body charged with the prime responsibility of supervising, licensing and monitoring the activities of market intermediaries, including the stock exchange and the central depository and settlement system and all the other persons licensed under the Capital Markets Act. It plays a critical role in the economy by facilitating mobilization and allocation of capital resources to finance long term productive investments.

Cryptocurrencies that qualify as securities are regulated under the CMA. According to CMA, "securities" include the following: shares; debt instruments; right options relating to other securities; future options relating to assets or property; depositary receipts; asset-backed securities; interests, rights, and properties commonly viewed as securities; or any other instrument classified as a security by CMA. Thus, even though CMA has not yet classified cryptocurrency as securities, the legislation empowers CMA with the broad discretion to classify certain cryptocurrencies as securities.

To determine if a cryptocurrency is a security, Kenyan courts apply the Howey test. Under the Howey test, an investment classifies as a security if it involves a contract, transaction, or scheme whereby a person invests their money in a common enterprise for the expectation of profits derived solely from efforts of a third party. Since the Howey test involves questions of fact, whether a specific cryptocurrency is a security must be determined on a case-by-case basis.

CMA suggests two approaches for cryptocurrency regulations. The first suggestion is to form a working coalition where Kenya's financial regulators collaborate to regulate cryptocurrencies. CMA's second suggestion is to create an agency that would serve as the primary cryptocurrency regulator in Kenya. Regardless of which is chosen, both approaches would increase the consistency and uniformity of cryptocurrency regulations in Kenya.

Kenya Revenue Authority

Tulipe Ushuru, Tujitegemee!

Kenya Revenue Authority (KRA)

The Kenya Revenue Authority is charged with collecting revenue on behalf of the government of Kenya. The core functions of the Authority are to assess, collect and account for all revenues in accordance with the written laws and the specified provisions of the written laws, to advise on matters relating to the administration of, and collection of revenue under the written laws or the specified provisions of the written laws and to perform such other functions in relation to revenue as the Minister may direct.

In November 2019, the Kenyan government passed amendments to the Income Tax Act of Kenya. These amendments introduce the "digital service tax." According to KRA, the digital service tax applies to cryptocurrency transactions as well.

Traders on digital marketplaces must pay cryptocurrency taxes or face civil liability. Under Kenyan law, digital marketplaces are defined as electronic platforms that facilitate "the direct interaction between buyers and sellers of goods and services through electronic means." KRA declared that cryptocurrency platforms are included in the broad statutory definition of "digital marketplaces." Specifically, cryptocurrency platforms are digital marketplaces because they provide an internet platform for buyers and sellers to trade cryptocurrency from anywhere in the world. One prominent example of a cryptocurrency platform is Coinbase. In applying Kenyan law, Coinbase is a digital marketplace because it permits traders to use its platform for cryptocurrency transactions through electronic means on the internet. Under Kenya's digital service tax, cryptocurrency transactions are taxed at a rate of 1.5%.

Under the digital service tax, only certain individuals may offset their cryptocurrency taxes by deducting their capital losses. Anyone with a permanent establishment in Kenya may offset their digital service tax against the tax payable for the preceding year of income. However, cryptocurrency traders that do not have a permanent establishment in Kenya are prohibited from offsetting their cryptocurrency taxes. Therefore, only Kenyan residents may lower their taxes by offsetting their losses from their taxable income.

To enforce the new tax laws, KRA plans to create a unique tax agency that specifically regulates cryptocurrency taxes. Accordingly, the 2019 amendments authorize the Commissioner of Income Taxes at the KRA to appoint agents to collect and remit digital services taxes in Kenya. The KRA's special agents will be authorized to collect digital service taxes from local and international cryptocurrency firms operating in Kenya.

In an effort to regulate crypto in Kenya, there has been a proposed amendment to the Capital Authority Act. Under the Capital Markets (Amendment) Bill, 2022, KRA will go after the more than four million Kenyans who own cryptocurrencies. The Bill seeks to introduce taxation of the crypto exchanges and digital wallets and imposes transaction taxes. Kenyans will also pay KRA capital gains for the increased market value of the crypto when they sell or use the digital currencies. Those who have made trading in cryptocurrencies a business are likely to be liable for income tax on their earnings. Overall, the Bill seeks to protect Kenyans from risks associated with the unregulated cryptocurrency trade.

8.5%

Kenya's population that owns digital assets

8.3% US population that owns digital assets

CBK in February this year invited public views on the potential introduction of a digital currency was to offer some benefits, especially in reducing cross-border payment costs.

> CBK is working on introducing a digital currency. The proposed Central Bank Digital Currency (CBDC) will be a virtual version of the shilling, exchangeable on a one-to-one basis with physical cash.

Cryptocurrency adoption in Kenya

A study conducted by the United Nations (UN) determined that 8.5% of Kenya's population own digital assets, which makes up around 4.25 million people. This makes the country a leader in cryptocurrency adoption across Africa, while globally, Ukraine ranks first, with 12.7% of its residents owning crypto.

It is worth noting that Kenya's crypto adoption rate surpasses top economies, including the United States (8.3%). However, it is hard to establish the value of digital currencies held by Kenyans due to the lack of supervision in the sector.

Citizens residing in Kenya view cryptocurrency as an attractive and affordable means to access financial services. Cryptocurrency also allows users to send funds faster and cheaper than the traditional method. During the start of the pandemic in 2020, traditional currency exchanges in Kenya charged consumers high rates to transfer funds globally. This subsequently encouraged many to opt for cryptocurrency to carry out their financial activities.

Kenya suffers from a hyperinflationary national currency. Over the past years, the Kenya Shilling has dropped significantly in value. The currency is continuously depreciating, which makes it difficult for citizens to meet their basic financial needs, especially for saving.

Kenyan investors buy cryptocurrencies to preserve their savings, carry out international transactions either for individual remittances for those working in places like Europe and North America or for commercial use, such as purchasing goods to import and sell. One of the reasons the CBK in February this year invited public views on the potential introduction of a digital currency was to offer some benefits, especially in reducing cross-border payment costs.

The CBK issued a press release in 2015 stating its stand on the use of cryptocurrency. It declared that cryptocurrency is an unregulated digital currency not issued by the central bank or any government. It stated that Bitcoin and other cryptocurrencies like it are not legal tenders in Kenya. Regardless of this statement, Kenyans continue to use cryptocurrency.

To address this, CBK is working on introducing a digital currency. The proposed Central Bank Digital Currency (CBDC) will be a virtual version of the shilling, exchangeable on a one-to-one basis with physical cash. The government will have control over the amount of CBDCs in circulation. This will ensure that there is no shortage or oversupply of digital currency, likely leading to deflation or inflation. The centralization of digital currencies allows the central bank to address problems or issues arising from transactions. The regulator will also retain the power to freeze, flag or cancel certain transactions that violate financial laws.

Taxation

Countries are now seeking to tax cryptocurrency traded through exchanges. Tax is due when it is sold, traded, or disposed of in any way and recognized as a gain but taxation varies depending on how and when it was acquired. Whether cryptocurrency is subjected to capital gains tax, VAT or income tax has been a subject of discussion in different jurisdictions.

The Capital Market Amendment Bill in Kenya will mandate that individuals who hold or deal in digital currency submit particular information to the Capital Markets Authority (CMA) for tax purposes. Further, they will be required to inform CMA what kind of virtual currency was used, when it was bought and sold, and how much it cost. The bill states that everyone who owns or transacts in digital currency must submit to the Authority the amount of transaction proceeds, any associated costs, and the amount of any gain or loss on the transaction for purposes of taxation.

Taxing cryptocurrency as Capital Gains Tax

Cryptocurrency will be subject to capital gains tax in the instances where an individual has held digital money for more than twelve months. This is because the value fluctuates, and depending on how that value has changed. One may realize a capital gain or loss when disposing of a property or trading it in. Capital gains from crypto will only be realised from a tax perspective when the asset is sold.

Since capital gains tax (CGT) is set to be levied at the rate of 15% of the gain and paid by the seller or the transferor of the property, it, therefore, means that the digital currency shall be taxed at the same rate of 15% starting from 1st January 2023 and the same shall be remitted by the seller or the transferor of the currency.

However, it is not clear whether digital currency shall be charged on the net gain accrued by a resident or non-resident company or individual upon the transfer of the digital currency as it operates under CGT.

How CGT on crypto operates in other jurisdictions

In the US, cryptocurrency is taxable as capital gains when one sells it for cash and as a result of the sale, one receives a higher price than the original purchase price.

In case one incurs a loss after selling, a person might be eligible to claim a tax deduction. Secondly, CGT is applicable when converting from one cryptocurrency to another and finally when using crypto to pay for goods and services.

Taxing crypto as Income Tax

When holding digital money for less than or equal to twelve months, digital currency shall be governed by the laws governing income tax.

If an individual receives crypto as payment for business purposes, the same will be taxed as business income. This means that those engaging in cryptocurrency trading as a business will be obligated to pay income tax on their income.

How income tax on crypto operates in other jurisdictions

Income tax is levied on crypto when an individual is paid in crypto, the same is taxed as income, when receiving cryptocurrency in return for goods or services and when cryptocurrency is mined, an individual is obligated to pay taxes on income based on the fair market value of the coins received.

Mining cryptocurrency is subject to self-employment income. Crypto is taxed under income tax in earning staking rewards whereby staking awards are taxed according to their fair market value on the day received when a return is earned by holding certain cryptocurrencies, when one receives airdrops from a crypto company as part of a marketing campaign or giveaway and finally when an individual receives incentives or rewards as a result of crypto including rewards or incentives for referring a friend to a crypto exchange.

On the other hand, digital currency falls under the precincts of the digital economy. In 2020, Kenya introduced two types of taxes targeted at the digital economy, namely; Digital Service Tax (DST) and Value Added Tax on Digital Marketplace Supply (VAT-DMPS). These taxes mainly target businesses that are not resident in Kenya. Resident and non-resident entities who offer digital services that are within the scope of DST in Kenya are liable to DST payable at a rate of 1.5% of the gross transaction value.

Buying and Selling Cryptocurrency

Crypto exchanges function similarly to online brokerage platforms, providing tools to buy and sell digital currencies and tokens like Bitcoin, Ethereum, and Dogecoin. A cryptocurrency exchange is an online marketplace where users buy, sell, and trade cryptocurrency. Crypto exchanges work similar to online brokerages, as users can deposit fiat currency (such as U.S. dollars) and use those funds to purchase cryptocurrency. Users can also trade their cryptocurrency for other cryptocurrencies, and some exchanges allow users to earn interest on assets held within the exchange account. Some main crypto exchanges in Kenya include:

Cex.io
Cex.io is a multifunctional cryptocurrency exchange recognized by millions of customers across the world, enabling consumers to purchase bitcoin with a credit card or debit card in a simple and safe manner.

Paxful
Paxful, a peer-to-peer Bitcoin trading network, was founded in 2015 and facilitates buyers and sellers to directly connect by posting exchange offers.

Changelly
Changelly is a real-time cryptocurrency exchange that provides the best live prices for each pair.

Bitsquare
Bitsquare is a peer-to-peer bitcoin exchange that enables users to purchase, sell, and swap bitcoins for other cryptocurrencies and fiat currencies.

Risks

Hacking

Though bitcoin is often cited as 'hack-proof' because it is built on blockchain technology which is considered secure by design, this is not the case.

There exist certain instances when a block chain can be hacked such as in the case of 51% attacks, where hackers gain majority control when mining the coin, or in the case of creation errors which occur when the blockchain is being set up or on exchanges.

Majority of the hacking has occurred on exchanges and hackers have made off with serious money. One of the problems is that virtually anyone can start an exchange and usually when they do they employ few cybersecurity professionals making it difficult to keep up with the cybersecurity details.

Volatility

Since its inception as the first cryptocurrency, bitcoin did well growing in value and worth and bringing the attention of the world to cryptocurrencies. Early adopters gained immensely from investing in it. But this growth has also been volatile making it a risky investment. Its volatility also contributes to the cost of converting it into other cryptocurrencies and also fiat currencies.

Regulation issues

Both the lack of regulation and the threat of too much regulation makes it risky to hold cryptocurrencies. The FTX crash also shows that the lack of regulation led to a lack of internal financial controls which resulted in the misuse of clients' money.

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