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EFFECT OF CAPITAL GAINS TAX ON PERFORMANCE OF REAL ESTATE BUSINESSES IN MAVOKO MUNICIPALITY, MACHAKOS COUNTY-KENYA

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Abstract

The current study sought to establish the effect of capital gains tax on performance of real estate businesses in Mavoko Municipality, Machakos County. The study used descriptive research design where the target population under study constituted all the 143 employees of 31 real estate companies operating in Mavoko and which are registered with relevant department of Machakos County Government. The study used primary data which was collected using an open and closed ended Likert scale questionnaire. The data was then analyzed using SPSS V23 where Correlation Coefficient was used to determine the strength and direction of the relationship between the dependent variable and each of the independent variables while coefficient of determination will be used to measure the proportion of variance in the dependent variable that can be explained by independent variables. ANOVA, T- and F- tests will be used to test the significance of the model in measuring the relationship between capital gains tax and performance of real estate businesses in Mavoko Municipality, Machakos County at 95% confidence level and 5% significant level. The study established that there was a significant positive relationship between capital gains and performance and a non-significant positive relationship between capital allowances and performance. However, significant negative relationship between performance and lock in effect was established. Performance and

capitalization effect was found to be having an insignificant negative relationship. A conclusion was therefore made that there exist a significant relationship between capital gain tax and performance. A recommendation was made that real estate businesses do not need to put much resources in claiming for the capital allowances and deductions since though they use a lot of resource to claim, their contribution to overall performance is insignificant.

Keywords: Capital Gains Tax, capitalization effect, lock-in effect, Real Estate Business, Performance

INTRODUCTION

Capital gain tax was first introduced in Kenya in the year 1975 but suspended 10 years later with an objective of spurring investment in real estate as well as in the securities market. Some scholars like Ricardo and Erosa (2007) suggested lock in effect and capitalization effect as measures of the impact of CGT. Lock-in effect occurs when taxpayers delay selling investments that have large unrealized gains with an aim of avoiding the immediate tax hit while capitalization effect concept discusses the impact of capital gain tax on demand for property. Buyers bargain for a low price for real estate property so as to compensate for the CGT which they will pay when they sells the property in future.

In Kenya, real estate property covers all property categories including residential houses, agricultural land and commercial land, offices, warehouses and go-dawns, retail outlets and shopping complexes (Masika, 2010). Statistics indicate that the demand for housing, which has possibly led to increase in house prices, has been on the rise at a faster rate than the number of houses available or under construction. The estimate number of houses constructed annually is about 30,000 whereas the demand is estimate at 150,000 (National Housing Survey, 2013). Specifically In Mavoko Municipality where the study was carried, there are so many upcoming developments that are affecting this Municipality, such as the standard gauge railway and Konza city. This has created competition from developers who are rushing to tap into the once rural areas. Such competition has a role in the surge of property prices. As developers build in these new places, prices also go up.

LITERATURE REVIEW

The literature will be reviewed in relation to the concept of capital gains, capital allowances, lock in effect and capitalization effect. A study conducted by Omboi (2011) on the factors influencing real estate property prices in Meru Municipality using income of real estate investors, location of

a real estate property, demand and realtors and brokers as the variables established that, other factors remaining constant, income from real estate property was the key factor influencing real estate property prices in Meru Municipality and accounted for more than 70% of the changes in property prices. Demand for real estates in Meru which contributed to 20% of the changes in prices was found to be the second most important factor influencing real estate prices while location of the property and realtors and brokers were found to be insignificant in determining property prices in Meru Municipality. They concluded that the performance of real estates in Meru depends on the income derived from the said real estate. Thus according to the findings, the capital gain from the real estate property is a major determinant of performance of real estate business.

Also, Hou (2010) conducted a study in Beijing and Shanghai, two cities in China with an aim of determining if there was housing price bubble. The findings found that between 2005 and 2008 Beijing appeared to have been on the way of forming a housing price bubble while in Shanghai, housing bubble perhaps existed from 2003 to 2004. Due to bubble forming Beijing market was divided into three stages which are cycle peak stage (1991-1997), cycle trough stage (1998-2003) and the second cycle peak stage (2004-2008). These three stages were characterized by bubble effect and rapid real estate growth. Thus this study highly supports the fact that the increase in value of a property has the effect of making the property market to boom in nature. The above study was supported by the report by Knight Frank's (2011) Prime International Residential Index (PIRI), which shows that Kenya's luxury real estate saw the greatest price increase globally with the value of Nairobi's prime real estate growing by 25% while at the Kenyan coast by 20%. The growth of real estate in Kenya was higher than in other major cities like Miami (19.1%), London (12.1%), Moscow (9.8%), New York (3.1%), Shanghai (-3.4%) and Singapore (4.7%). It is expected that the bubbling effect is the reason behind emergence and growth of real estate business due to the increased prices of real estate assets. Governments through capital allowances attempt to influence physical and financial capital. Capital allowances are usually in form of Investment Deduction (ID), wear and tear allowances (WTA), among others. The Income Tax Act provides for various tax incentives through capital deductions. In Kenya, the government has allowed a claim of 150% for companies who invest outside Nairobi, Mombasa and Kisumu cities and incurring expenditures of more than 200 million. If the investment is done inside the three cities, the investors are allowed to claim Investment Deduction at a rate of 100%. These capital allowances are form of tax incentives aimed at attracting investors in given areas of the country. Using descriptive design, Njeru and Ndimitu (2015) assessed the effect of tax incentives on performance among Export Processing Firms (EPZs) in Kenya. Specifically, they looked at effect of ID, IDB and WTA on performance

among Export Processing Firms (EPZs) in Kenya. The findings from the study revealed that investments in EPZ firms increased with increase in sales, profit as well as tax incentives. However, the influence of tax incentives on investments in EPZ was insignificant. Some of positive impact of various tax incentives given to the EPZs included increased foreign exchange earnings for the country, tax breaks, increased gross exports that are used to boost business investments in the country, high quality manpower, good source of labor training and learning by doing and assisting countries in developing an industrial labor force as well as procedural incentives. Negative impacts, on the other hand include the administration is legally complicated and conflictive; unhealthy competitions in the manufacturing sector caused by the tax incentives to the EPZ.

Another study that was conducted by Devereux, Maffini and Xing (2015) and it focused on effect of corporate tax incentives on firm performance. They used data obtained from confidential tax return data combined with the data from financial statements for a panel of companies in the UK that were in operation between the fiscal years 2001/2002 - 2009/2010. The findings indicated a strong response to the corporate tax incentives that were extended to both the domestic standalone companies as well as the multinational companies based on their external leverage. They found the evidence that corporate tax incentives affected the external leverage of both domestic and multinational companies.

Using 1400 institutional investors in their study, and focusing on establishing the relationship between capital gain taxes and the lock in effect on investors' decision making in short term and long term, Chyz and Oliver (2012) examined the Lock in Effect of CGT on investors. The results from the study indicated that increase in capital gain taxes had negative lead to lock in effect. The investors were observed to hold on to their current securities to avoid the high costs of transaction that arise as result of high CGT. However, with reduction of CGT, the investors were willing to sell their current securities and acquire more securities in their portfolio. Where CGT was high, the firms reported reduced profits but increased profits when the CGT is low. Also, using weekly returns and trading volume from January 1, 1995 to December 31, 1997 and focusing on the 1997 capital gains tax rate cut, Dai, Maydew, Shackelford, and Zhang (2010), empirically test their predictions on effect of CGT rates on capitalization and lock in effect. Consistent with their predictions, they found evidence of both the capitalization and the lock-in effect. In particular, the capitalization effect dominates the lock-in effect the week between news of the CGT rate reduction and the effective date of the rate cut, reflecting anticipation of the proposed tax cut making it into law. Weekly stock returns during the capitalization week are on average higher by around 5 to 8 percent than average weekly returns. In contrast, the lock-in effect dominated the capitalization effect during the first

week after the rate reduction becomes effective. The weekly stock returns are on average 1 to 3 percent lower during the lock-in week. Stocks with large embedded capital gains and high percentage of individual investor and mutual fund ownership experience lower returns on average during the lock-in week. A one standard deviation increase in the two year embedded capital gains leads to 2.4 percent lower weekly returns during the lock-in week for firms with average percentage of individual investor and mutual fund ownership. Their study suggests that CGT rates changes cause both capitalization and lock in effect. Both the capitalization effect and lock in effect has influence on the number of shares traded in any security market.

Sialm (2009) conducted a study to investigate on the capitalization effect of capital gain in the United States. The study sought to investigate on the tax burden on equity securities. In this study Sialm analyzed the compensation for tax burden between the years 1913 to the year 2006. Results indicated that over this period, the CGT varied over time. A cross section study revealed that increase in capital gain taxes contributed to the capitalization effect. When capital gain taxes were high, buyers were observed to prefer low prices on the securities. The low prices were preferred since buyers wanted to be compensated for the capital gain taxes they would pay while selling the securities later. This low prices coupled with less demand could lead to low performance of a business venture. In his study, Coleman (2008) aimed at understanding how CGT charged on real estate would affect the economy. Coleman (2008) developed a model to analyze long term effect of CGT in New Zealand. In his study Coleman used 400 participants who were house agents. Coleman (2008) observed that as a result of introducing capital gain taxes the amount of rent increases. Due to increased rent expense individuals prefer to own houses to avoid paying rent. Therefore, it encourages people to own their own homes meaning people will buy their own homes leading to increase in demand for homes which leads to decreased capitalization effect. However, it also reduces the savings of the tenants due to increased rent expense. Lau and Berlin (2014) did a study to establish the impact of CGT on the asset pricing model. Their study involved major institutional investors in Germany. These institutional investors were considered to have high knowledge in taxation and valuation of securities. The study revealed that the flat rate of CGT that had been announced by the Germany government in the year 2009 on the private capital lead to massive increase in trading in securities. The study revealed that the demand for securities increased by 60% within two days after the rate was flat. Results from the study shows that reduced CGT leads to increase in demand for security. Consequently, increase in CGT will lead to reduced demand (capitalization effect) for securities hence reduced investment in securities.

From the literature, a couple of studies have been carried out to determine effect of CGT on economy. For example, Global Tax Alert (2015) did a research entitled, Kenya reintroduces

CGT, Okoth (2015) also did an article by the title, and KRA now demands CGT from stockbrokers. Looking at the studies done on CGT in Kenya, they are not only few, but also none of them have tried to link the reintroduction of CGT to performance of real estate businesses. This research with therefore try to link the performance of real estate businesses in Kenya with CGT in addition to adding to the literature relating to CGT.

Conceptual framework

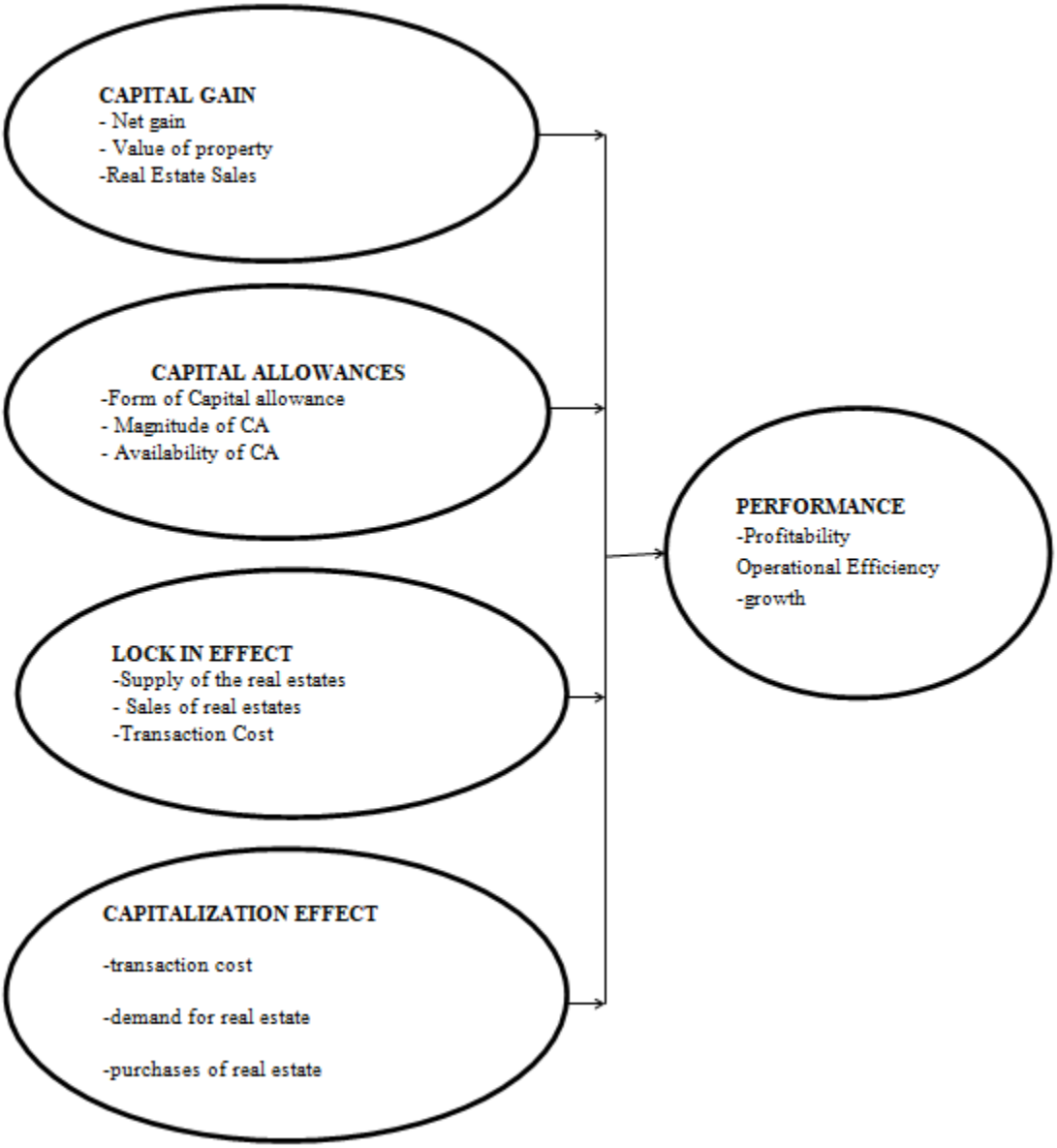

Figure 1: Conceptual Framework

Capital gain was the first component of capital gain tax while the second component of capital gain was capital allowances. The third component of capital gain tax was lock in effect and the last component was capitalization effect. The dependent variable was performance and its indicators were profitability, operational efficiency and growth of real estate businesses.

STATEMENT OF THE PROBLEM

In Kenya, CGT was first introduced in the year 1975 but later suspended in the year 1985 with an objective for the suspension was to spur investment in real estate as well as in the securities market. Since its suspension, real estate property market has been booming due to among other factors increased availability of financing through mortgages (Masika, 2010). Data by property index and management firm Hass Consult (2012) show that the average value for a property in Nairobi, in the year 2000 was Ksh 7 million and in the year 2007 same property was at an average of Ksh 24 million this shows that property values have increased by 3.38 times since 2000. This was in agreement with findings that Real estate prices in Kenya have more than doubled in the past few years and the supply continues to be outweighed by the demand (Masika, 2010). However, after nearly 30 years of suspension, KRA announced to reintroduce it back by use of on 19th September 2014 with an applicable rate of 5% of the net gain and become effective on 1st January 2015 (www.kenyalaw.org). After its reintroduction, Kenya Insight Report (KIR) on real estate prices by Macharia, (2018) reported that prime residential prices reduced by 1 percent in 2016 while prime residential rents in Nairobi declined by 3.2 percent in 2016 and2.8 percent in 2017. There was need to do a research to determine whether the decline in prime residential prices, prime residential rents and low transaction volumes of real estate property could be related to introduction of CGT.

METHODOLOGY

The researcher used design descriptive research design. Mugenda and Mugenda, (2003) defined research design as the way the study is designed, that is, the method used to carry out the research. According to Shields, Patricia and Rangarajan (2013), descriptive research is used to describe characteristics of a population or phenomenon being studied. It does not answer questions about how/when/why the characteristics occurred. Rather it addresses the "what" question (what are the characteristics of the population or situation being studied?).Thus it gives a general overview as to what variables are worth testing quantitatively. Descriptive research involves collection of data aimed at answering questions about the subjects been studied. The target population for this study was the 143 employees of 31 real estate companies registered within the Municipality under the Department of Transport, Roads,

Public Works and Housing of County Government of Machakos in the category of limited liability companies. A survey of all of 143 employees was done. Closed ended structured self-administered questionnaires with a Lirkert scale was used to collect the primary data. Questionnaires were presented to each of the REB and then collected after two weeks to analyze the data.

The collected data was sorted, cleaned, coded and then entered into Statistical Package for Social Science (SPSS) version 23 for production of descriptive statistics and inferential statistics which was used to analyze the data. The analytical model for this study was developed from Teng, Bhatia and Anwar (2011) who used a similar model and it was as below:

$$Y= \beta 0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$$

Where:

Y is performance of real estate businesses, X_1 reflects the capital gains by the firm, X_2 reflects the capital allowances given to firms, X_3representsthe lock in effect due to CGT, X_4 represents the capitalization effect due to CGT, β_0 is Constant term, $\beta_1 - \beta_4$ are regression coefficients which define the amount by which dependent variable is changed for every unit change in the independent variable and ε is the error term to capture unexplained variations in the model and which is assumed to be normally distributed with mean zero and constant variance.

FINDINGS

After the data was collected and analyzed, it was then presented in tables. the following tables shows the findings for a study whose objective was to determine the effect of capital gains tax on performance of real estate businesses in Mavoko Municipality of Machakos County, Kenya.

Table 1: Correlation matrix

		Performance	Capital gain	Capital allowance	Lock-in effect	Capitalization effect
Performance	Pearson Correlation	1	.542**	.393**	-.521**	-.401**
	Sig. (2-tailed)		.000	.004	.000	.006
	N	113	113	113	113	113
Capital gain	Pearson Correlation	.542**	1	.557**	.571**	.648**
	Sig. (2-tailed)	.000		.000	.000	.000
	N	113	113	113	113	113
Capital allowances	Pearson Correlation	.393**	.557**	1	.365**	.547**
	Sig. (2-tailed)	.004	.000		.008	.000
	N	113	113	113	113	113

Lock-in effect	Pearson Correlation	-.521**	.571**	.365**	1	.702**
	Sig. (2-tailed)	.000	.000	.008		.000
	N	113	113	113	113	113
Capitalization	Pearson Correlation	-.401**	.648**	.547**	.702**	1
effect	Sig. (2-tailed)	.006	.000	.000	.000	
	N	113	113	113	113	113

Table 1…

**. Correlation is significant at the 0.01 level (2-tailed).

The results on the table above show a strong positive correlation between business performance and capital gain of 0.542 and weak positive correlation of 0.393 between capital allowances and performance. However, a negative correlation of 0.521 and 0.401 exist between lock-in effect and capitalization effect with performance respectively. In all cases, the correlations are significant at 0.01 significant levels. These findings indicate that an increase in lock in effect and capitalization effect will lead to decrease in performance while increase in capital gains and capital allowances will lead to increase in performance.

Table 2: Model summary

Model	**R**	**R^2**	**Adjusted R^2**	**Std. Error**	**Change Statistics**				
					R^2 Change	F Change	df1	df2	Sig. F Change
1	.711[a]	.506	.457	.784	.506	10.241	4	108	.000

Predictors: (Constant), capitalization effect, capital allowances, Lock-in effect and capital gain

Dependent variable: Performance

The table 2 shows that the R value is 0.711, while the value of r-squared is 0.506. Value of Adjusted R Square was found to be 0.457 and an F Change value of 10.241. The Sig. F Change value was found to be 0.000. The results indicate that the regression model is fit and that there is a significant association between business performance and the other independent variables.

Table 3: ANOVA

Model		**Sum of Squares**	**df**	**Mean Square**	**F**	**Sig.**
1	Regression	25.185	4	6.296	10.241	.000[b]
	Residual	24.592	108	.615		
	Total	49.778	112			

Dependent variable: Performance

The value of the f-statistics (10.241) is statistically significant at a 95% confidence interval and 0.005 alpha levels. The results indicate that the regression model is fit and that there is a significant association between business performance and the other independent variables.

Table 4: Regression coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	.106	.301		.353	.726
	Capital gain	.418	.221	.309	1.890	.046
	Capital allowances	.231	.151	.218	1.533	.133
	Lock-in effect	-.694	.197	-.573	-3.530	.001
	Capitalization effect	-.300	.183	-.297	-1.634	.110

Dependent Variable: Performance

From the table above, the constant term was 0.106 with a significant value of 0.726 while the capital gain and capital allowances have a beta value of 0.418 and 0.231 respectively. Their significant values were 0.046 and 0.133 respectively. Lock in effect and capitalization effect has beta values of -0.694 and -0.300 accompanied by significant values of 0.001 and 0.110 respectively.

Since p values for the constant term and independent variables are accompanied by large /t/ value, then $\beta 0 \neq \beta 1 \neq \beta 2 \neq \beta 3 \neq \beta 4 \neq 0$ and therefore the predictor variables have significant impact on performance of real estate businesses in Mavoko Municipality. The specific model therefore becomes $\mathbf{Y= 0.106 + 0.418X_1 + 0.231X_2 - 0.694X_3 - 0.300X_4+\varepsilon}$

CONCLUSIONS

The first objective of the research was to determine the effect of capital gain on performance of real estate business in Mavoko Municipality, Machakos County. The study findings shows a statistically significant positive relationship between business performance and capital gain meaning that a unit increase in capital gain will lead to a significant increase in performance of a real estate business. A conclusion that there exist a direct relationship between performance and capital gain in real estate business was made and therefore managers and other stake holder in real-estate sector should concentrate on finding ways of increasing the level of capital gain of their estate firms since it's a major determinant of performance in real estate sector.

The second objective was to establish the effect of capital allowances on performance of real estate business in Mavoko Municipality, Machakos County where a statistically insignificant positive relationship between business performance and capital allowances was established. A conclusion that capital allowances is a factor that should be considered by real estate firms in their effort to increase their performance was made since they lead to increase in overall performance of real estate business. However, manager of these real estates need not to put much resources in claiming those capital allowances since their effect is insignificant.

The third objective was to find out the relationship between lock in effect and performance of real estate business in Mavoko Municipality, Machakos County. The findings showed a negative and significant association between lock in effect and business performance. A conclusion is made that there is an inverse relationship between lock in effect and business performance in real estate business in Mavoko Municipality.

The last objective was to determine the relationship between capitalization effect and performance of real estate business in Mavoko Municipality, Machakos County where the findings established a negative and in insignificant relationship between capitalization effects with business performance. A conclusion that there is an inverse relationship between capitalization effect and performance of real estate businesses was made meaning that emphasis needs to be given to this effect. Buyers of real estate property shy away from buying new estate property to avoid the associated transaction costs relating to the Capital Gains Tax. The sellers need to be aware that they need to relax the transaction conditions so as to attract more customers and avoid occurrence of capitalization effect that could adversely affect the performance of the real estate ventures.

RECOMMENDATIONS

To the government through its tax authority Kenya Revenue Authority, I encourage them to carefully consider the effect of taxation of capital gains to performance of real estate businesses. Too much Capital Gains Tax is charged on real estates, undesirable effects like capitalization effect and lock in effect may occur. Capitalization effect and lock in effect have the effect of reducing the performance of real estate businesses as both sellers and buyers keep away from engaging in real estate transactions in an effort to reduce the transaction costs.

To the manager of real estate firms, and those investors who are planning to start real estate firms, they should use the findings of this study to decide on which factors to consider in the day to operation of their real estate so as to maximize profits. For example, the findings show insignificant positive relationship between capital gain tax and performance. Managers should not invest much resource in claiming these capital deductions since they bring no much profit.

The research findings show significant relationship between Capital Gains Tax and performance of real estate businesses. It suggested that the independent variables explain 50.6% of the variation in the dependent variable meaning 49.4% can only be explained by other factor. The research recommends that other scholar do a research that will be aimed at coming up with more components of Capital Gains Tax and how they're likely to affect the performance of real estate businesses. Some findings of this research contradict earlier findings by other scholars. For example, Devereux, Maffini and Xing (2015) had suggested significant negative relationship between capital allowances and performance while the current study shows a negative insignificant relationship. We encourage other scholars to research on whether time or geographical differences could be the cause of discrepancies.

LIMITATIONS OF THE STUDY

The reluctance of respondents to give responses to the questionnaire especially concerning the capital gains and capital gain tax paid was a big challenge to this study. Most respondents felt that the research was digging much to the privacy of their tax compliance. However, they were reassured that the research was purely for academic purposes and that none of the findings was to be shared with either their competitors or tax authorities. Another limitation was lack of adequate literature on Capital Gain Tax in Kenya since this is relatively a new term in Kenya. There were very few studies done on this area in Kenya, and the few which were done are very recent. However, this problem was solved by using the little literature available locally strengthened by the literature obtained from other countries where Capital Gain Tax has been active for long. Accounting for capital gain tax is totally a new principle to many especially those who are not in the accounting department. The fact that this type of tax is very new in Kenya made many respondents to have difficulties in filling the questionnaires since most of them had only the basic financial accounting knowledge. This was solved by taking time to explain to the respondents about what the research was all about, and the meaning of some complex terms used in the questionnaire.

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