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THE ANNOUNCEMENT EFFECT OF CAPITAL GAINS TAX ON FOREIGN PORTFOLIO INVESTMENT FOR FIRMS LISTED AT THE NAIROBI SECURITIES EXCHANGE, KENYA

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Abstract:
Foreign investment is important for growth of any country since it enables flow of capital, resources and skills from one country to another. Foreign portfolio investment enables investors to invest in securities in a foreign country and this has various benefits to the host country. The government of Kenya re-introduced capital gains taxes in 2015 after a 30 year suspension in a bid to increase tax revenue to finance various projects. This tax was to be charged at a rate of 5 percent of the net capital gain. The reintroduction of the capital gains tax (CGT) had an effect on the foreign portfolio investment as some of the foreigners opted for other markets and form of investments. Eight months prior to reintroduction of CGT the average foreign portfolio investment was 53.08% of the overall Equity Market at the Nairobi Securities Exchange market. One month to the effective date of the CGT, the level of foreign portfolio investment dropped to 32.37% giving a percentage drop of 20.71% from the average participation. The changes in the percentage of foreign investors may or may not have been significant, based on the abnormality of the changes. The study used a longitudinal descriptive research design which looked at the percentage changes in foreign portfolio investment at the NSE as a result of the announcement of the capital gains tax

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reintroduction. The study used secondary data from the Nairobi Securities Exchange to answer the research question. The foreign shareholding was collected as at the end of each 6 months, before and after the announcement month. Another set of data was collected for 6 months before announcement of the tax suspension and 6 months after the suspension. This data was analysed using events study, where abnormal foreign shareholding changes were calculated and assessed to determine whether it was significant. This was done using SPSS v.21 software. From the analysis, the study findings indicated that capital gains tax had a significant effect on foreign portfolio investment with decrease in foreign participation in the announcement month. With the findings, the study recommended that the government should come up with favourable tax policies to attract foreign investors and also to involve all stakeholders.

JEL: G24, O16, D24

Keywords: foreign portfolio investment, capital gains tax, Nairobi securities exchange, listing

1. Background of the Study

A securities exchange or a stock exchange is an organized and regulated financial market where shares, bonds and other securities are bought and sold at prices governed by the forces of demand and supply. Capital gain is realised through sale of a security at a price higher than the original purchase price. Capital gains tax is a tax on gains arising from disposal of assets. In Kenya, Capital Gains Tax was introduced in 1975 as Eighth Schedule to the Income Tax Act then suspended as from 13th June 1985 (KPMG, 2013). The Kenyan tax on capital gains was reintroduced by the Finance Act 2014 after being suspended for 30 years. The reintroduced capital gains tax was to be chargeable at a rate of 5% of the net gains on the transfer of property situated in Kenya and became effective on January 1, 2015 (Price Waterhouse Coopers, 2015). The net gain was to be determined as the difference between the consideration on the transfer of the capital asset and the adjusted cost of the asset (Muriuki, 2015). The adjusted cost in this case is the sum of the cost of acquisition of the asset, expenditure for enhancement and/or preservation of the property, and the incidental cost of acquiring the property (KRA website, 2016). Determination of the value of adjusted cost also brought confusion and big challenges due to the need for the historical data which would not be available for securities held prior to creation of Central Depository System at the NSE.

The tax on capital gains has been contentious in Kenya and other countries with investors indicating that it will inhibit proper redistribution of capital assets and investments. The Price water house report (2015) also indicated that there are no clear guidelines to implement the tax (Price water house Coopers, 2015).This report further indicates that it remains unclear how the reintroduced 5% final tax on capital gains from the transfer of property situated in Kenya should apply to indirect transfers of shares of companies in Kenya or companies that own property in Kenya. The Finance Act (2015) effectively suspended capital gains tax on sale of shares traded in listed companies and narrowed its scope to transfer of Kenyan property (Pricewaterhouse Coopers, 2015). Foreign portfolio investment at the Nairobi Securities Exchange has been significant. For the period January 2014 to December 2016, statistics show that the average monthly participation of foreign investors in the equity market was 60.18% with the highest participation being 83.18% in the month of September 2016 and the lowest participation being 32.37% in the month of December 2014.

Analysis of the announcement effect of capital gains tax on foreign portfolio investment is important so that proper decisions on tax administration can be taken by a country in order to attract foreign investors. Capital Gains Tax is administered on a withholding tax system where the tax is deducted by stock brokers from gains payable to the investor and accounted to the government by the stockbrokers (KRA, 2016). This means that foreign investors would be required to pay a final tax on their net gains from selling of marketable securities in Kenya a rate of 5 percent.

2. Statement of the Problem

Besides the direct impact of CGT on expected capital gains, the administration of the reintroduced tax required that the stockbrokers and investment bankers would compute the tax due on each transaction and pay the same to Kenya Revenue Authority on the due date. Stockbrokers protested against this implementation system and argued that the tax to be withheld belonged to the sellers and not the brokers and as such they should not be burdened by the requirements to account for the tax which was already too cumbersome due to the need for determining the original cost of the shares where such records did not exist.

Data from the Nairobi Securities Exchange indicated a decline in shareholding by foreign investors after the announcement of capital gains tax. Foreign investors' participation in equity market reduced from a monthly average of 52.28 percent for the nine months prior to the announcement of CGT, in mid-September 2014, to a low of 32.37 percent in December 2014, a month before the effective date of the tax. These statistics further show a drop of foreign investors' participation by 25.47 percent in December 2014 from the highest participation of 57.84 percent during the month of April 2014. Reductions in market participation coupled with the challenge of capital gains tax administration by stockbrokers led to government intervention. In order to address the concerns of the stakeholders, the government proposed to introduce a withholding tax of 0.3% on transaction value of traded securities. Whereas studies have been done on effect of CGT on share price and volume (Hanlon and Heitzman, 2010 and Eichfelder and Lau (2014), little study has been done with regards to foreign portfolio investment. These contextual and variable differences from the previous studies motivated this study, hence the research objective.

2.1 Research Objectives

The general objective of the study was to determine the announcement effect of capital gains tax on foreign portfolio investment for firms listed at the Nairobi Securities Exchange.

3. Methodology

The study used a longitudinal descriptive research design. The study had two events, that is, re-introduction and suspension of capital gains tax. The event window was 6 months before and after the re-introduction event (19th September 2014) and 6 months before and after the suspension period (15th September 2015). The effective dates of re-introduced tax (1st January 2015) and suspension of the tax (1st January 2016) were included in the event window of each study.

4. Findings of the study

4.1 Descriptive Data

Descriptive statistics were calculated for the study for a window period of 13 months, 6 months before, event month, and 6 months after the event to test whether there are significant changes in foreign portfolio investment at the NSE as a result of capital gains tax announcement. The results were as follows:

a) **Capital Gains Tax Reintroduction**

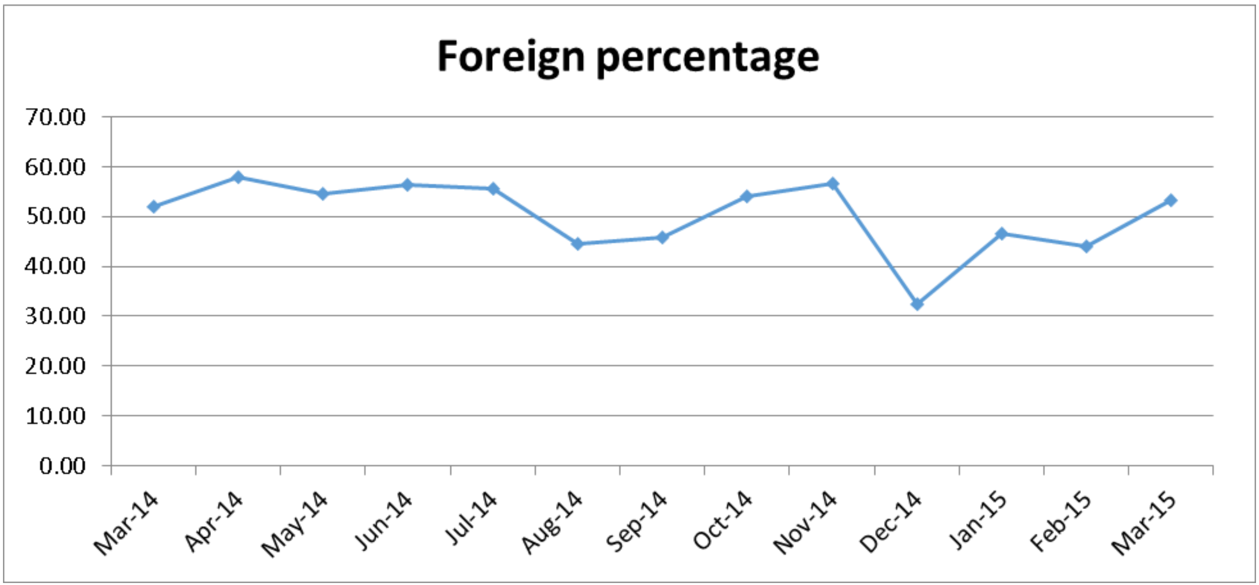

Figure 4.1: Foreign Shareholding Percentage between March 2014 and March 2015
Source: Researcher (2017)

The figure 4.1 above shows a monthly visual trend of foreign shareholding percentage at the Nairobi Securities Exchange during the capital gains tax reintroduction event period. The graph indicated a temporary increase in foreign shareholding percentage in the months of September 2014 to November 2014 and a significant dip in foreign shareholding percentage in the month of December 2014 to a value of 32.37% which is a month prior to implementation of the CGT. The temporary increase in foreign shareholding percentage was as a result of foreign investors reacting to the announced re-introduction of CGT, prompting them to increase shareholding in anticipation of short-term gains prior to implementation of the CGT. The decrease in foreign shareholding percentage in the month of December 2014 was as a result of the foreign investors selling off their shares prior to implementation of the CGT in January 2015. Similar observations were made by Eichfelder and Lau (2014) where the German Stock Market experienced temporary increase in trading volumes and asset prices and eventually a negative abnormal trading volumes and daily returns in the week following the effective date of the announced capital gains tax. Lo (2015) made similar observations where the stock trading volume in Taiwan capital market was significantly reduced as a result of implementation of capital gains tax.

The graph also indicates an upward trend in foreign shareholding percentage at the NSE from January 2015. This upward trend may have been caused by increased demand of shares by foreign investors prior to proper implementation of the CGT at the NSE. The delay in implementation was caused by court disputes over the implementation of the tax.

Table 4.1: Foreign shareholding between March 2014 and March 2015

Foreign shareholding percentage	
Mean	50.27
Median	53.18
Standard Deviation	7.248
Kurtosis	1.746
Skewness	-1.318
Minimum	32.37
Maximum	57.84
Count	13

Source: Researcher (2017)

Foreign shareholding between March 2014 and March 2015 had a mean of 50.27%, the highest shareholding percentage being 57.84% in April 2014 and the lowest price being 32.37% in the month of December 2014 which is a month prior to implementation of CGT. The standard deviation shows a value of 7.248 which is a shareholding percentage spread from the mean shareholding. The kurtosis (peakedness) had a value of 1.746, while skewness (asymmetry) had a value of -1.318. The values for asymmetry and kurtosis between -2 and +2 are considered acceptable in order to prove normal univariate distribution (George and Mallery, 2010).

b) Capital Gains Tax Suspension

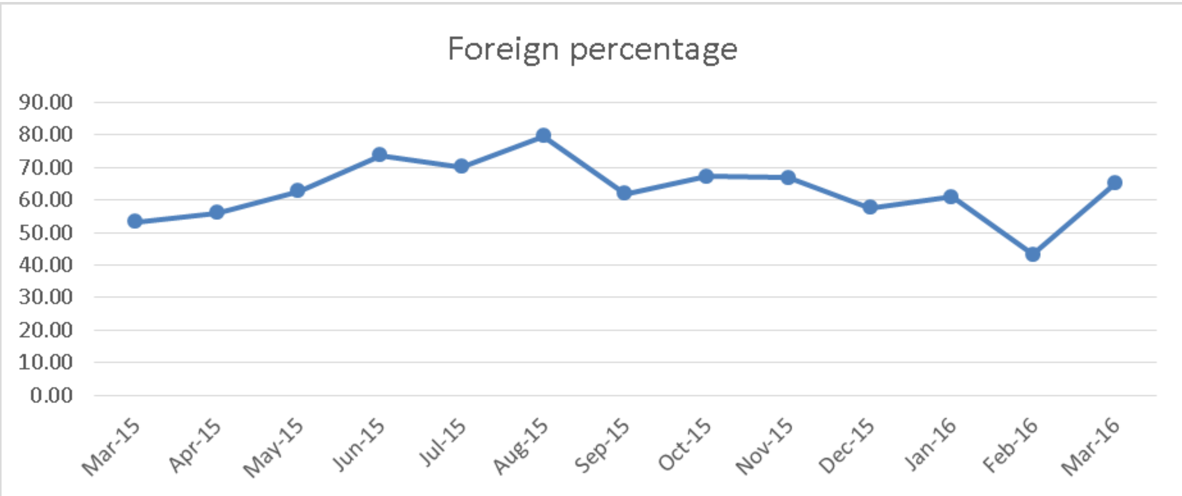

Figure 4.2: Foreign Shareholding Percentage between March 2015 and March 2016
Source: Researcher (2017)

Figure 4.2 above shows a monthly visual trend of foreign shareholding percentage at the Nairobi Securities Exchange during the capital gains tax suspension period. The graph indicated a slight increase in foreign shareholding percentage in the announcement month of the capital gains tax suspension followed by slight decline in the following month (October 2016). The slight increase of foreign shareholding in the announcement month implies that the foreign investors have no trading cost and can now buy more since they have no taxes when selling the shares.

Table 4.2: Foreign shareholding between March 2015 and March 2016

Foreign shareholding percentage	
Mean	62.93
Median	62.7
Standard Deviation	9.363
Kurtosis	0.718
Skewness	-0.321
Range	36.45
Minimum	43.18
Maximum	79.63
Count	13

Source: Researcher (2017)

Foreign shareholding between March 2015 and March 2016 had a mean of 62.93%, the highest shareholding percentage being 79.63% in August 2015 and the lowest percentage being 43.18% in the month of February 2016 which is one month after the CGT implementation. The dip after the CGT suspension could have arisen due to time lag effect where investors take time to adjust to decisions, or other factor(s) other than the CGT implementation. The standard deviation had a value of 9.363 which was the level of variability from the mean. The kurtosis (peakedness) had a value of 0.718, while the skewness had a value of -0.321 which implied that the data was normally distributed. These values for asymmetry and kurtosis are between -2 and +2; hence considered acceptable in order to prove normal univariate distribution (George and Mallery, 2010).

4.2 Inferential Statistics

4.2.1 Event Study

The event study analysed the effects of capital gains tax announcement on foreign portfolio investment which was the objective of the study. This was done for the two events of re-introduction and subsequent suspension of the tax. The results of the event study analysis were as follows:

a) Re-introduction of Capital Gains Tax

Event study was done during the re-introduction of capital gains tax and its effect on foreign portfolio investment at the Nairobi Securities Exchange. This was done for the period 6 months before and after the announcement while the window period was between 6 months and two months before the announcement.

Table 4.3: Capital Gains Tax Reintroduction Event Period

	t =	Month	Foreign portfolio investment percentage	Log foreign portfolio investment percentage	Abnormal foreign portfolio investment percentage
	-6	Mar-14	52.08	3.952780998	-0.059122667
	-5	Apr-14	57.84	4.057680578	0.045776913
	-4	May-14	54.50	3.998200702	-0.013702963
	-3	Jun-14	56.29	4.030516899	0.018613234
	-2	Jul-14	55.72	4.020339149	0.008435484
	-1	Aug-14	44.57	3.797060987	-0.214842678
Announcement Month	0	Sep-14	45.92	3.826900752	-0.185002913
	1	Oct-14	53.95	3.988057692	-0.023845973
	2	Nov-14	56.53	4.034771471	0.022867806
	3	Dec-14	32.37	3.477232068	-0.534671597
	4	Jan-15	46.71	3.843958275	-0.167945391
	5	Feb-15	43.92	3.782369797	-0.229533868
	6	Mar-15	53.18	3.973682386	-0.038221279
Average Foreign Trading Log				**4.011903665**	

Table 4.3 shows the event window of capital gains tax reintroduction announcement, foreign portfolio investment percentage, and the log-value of foreign portfolio investment percentage. Log values were used to normalize the data (remove skewness), cater for any outliers and better capture values in terms of ratios and not substantive values. The abnormal foreign portfolio investment percentage indicated the difference between the monthly log of foreign portfolio investment shareholding percentage and the event window average log of foreign portfolio investment shareholding. The results showed that there was a significant abnormal foreign portfolio investment percentage (-0.214) one month to the announcement (*t=-1*), and a value of -0.185 in the CGT announcement month (*t=0*). The results also showed a significant abnormal foreign portfolio investment percentage of -0.5347 one month prior to implementation of CGT on 1st January 2015.

4.2.2 Abnormal foreign percentage

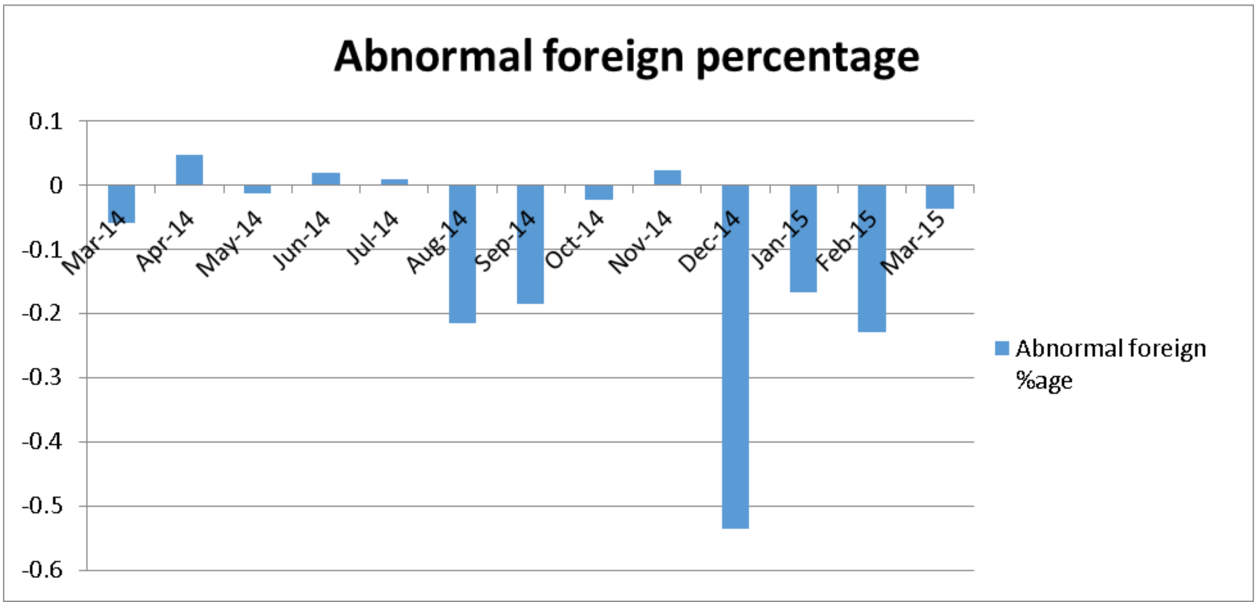

Figure 4.3: Abnormal Foreign Portfolio Investment Percentage after Reintroduction
Source: Researcher (2017)

Figure 4.3 above is a visual representation of the abnormal foreign portfolio investment percentage during the event period between March 2014 and March 2015. From the graph, it can be noted that there was greatest change in abnormal foreign portfolio investment percentage (value of -0.5347) in December 2014, which was one month before capital gains tax implementation date of 1st January 2015. The announcement month (September 2014) also had a significant reduction in foreign shareholding with a value of -0.18.

b) Suspension of Capital Gains Tax

Table 4.4: Capital Gains Tax Suspension Event Period

	t =	Month	Foreign portfolio investment percentage	Log foreign portfolio investment percentage	Abnormal foreign portfolio investment percentage
	-6	Mar-15	53.18	3.973682386	-0.164190101
	-5	Apr-15	56.06	4.026422546	-0.111449941
	-4	May-15	62.70	4.138361448	0.000488961
	-3	Jun-15	73.74	4.300545393	0.162672906
	-2	Jul-15	70.13	4.250350663	0.112478176
	-1	Aug-15	79.63	4.377390906	0.239518419
Announcement Month	0	Sep-15	61.95	4.126327608	-0.011544879

	1	Oct-15	67.19	4.207524427	0.06965194
	2	Nov-15	66.86	4.202600881	0.064728394
	3	Dec-15	57.53	4.052306551	-0.085565936
	4	Jan-16	60.92	4.109561528	-0.028310959
	5	Feb-16	43.18	3.765377425	-0.372495062
	6	Mar-16	65.02	4.174694915	0.036822428
Average Foreign Trading Log				**4.137872487**	

Table 4.4 shows the event window of capital gains tax suspension announcement, foreign portfolio investment percentage, and the log-value of foreign portfolio investment percentage. Log values were used to normalize the data (remove skewness), cater for any outliers and better capture values in terms of ratios and not substantive values.

The abnormal foreign portfolio investment percentage indicated the difference between the monthly log of foreign shareholding percentage and the event window average log of foreign shareholding. The results showed that there was a significant abnormal foreign portfolio investment percentage (0.239) one month to the suspension announcement (*t=-1*), and a value of -0.011 in the CGT suspension announcement month (*t=0*), and a value of 0.069 one month after the CGT suspension announcement (*t=1*). The significant abnormal foreign portfolio investment percentage (0.239) in August 2015 was caused by the proposed withholding tax of 0.3% on the value of capital gain realised instead of the CGT at 5%. The withholding tax of 0.3% was proposed by the June 2015 Finance Bill. The positive effect of this Bill was felt by the market as it can be demonstrated by the significant abnormal values from June to August 2015.

4.2.3 Abnormal Foreign Percentage after Suspension

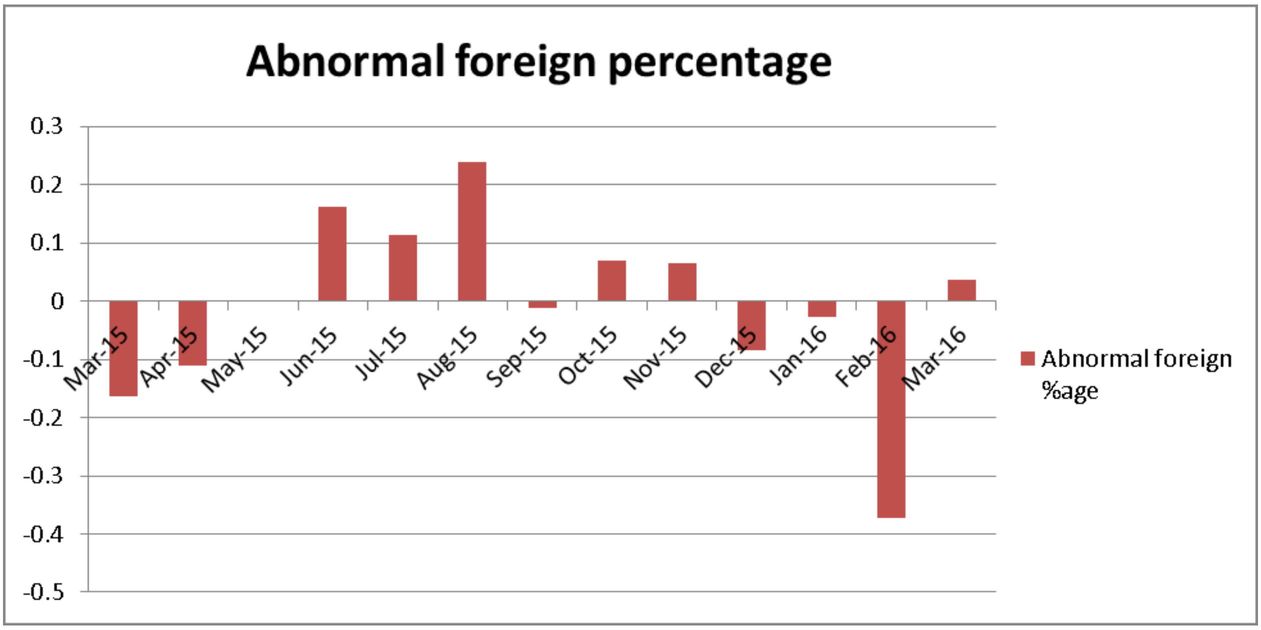

Figure 4.4: Abnormal Foreign Percentage after Suspension

Source: Researcher (2017)

Figure 4.4 above shows the abnormal foreign percentage which is the percentage log less the average log of the window period. From the graph, it can be seen that there was a great abnormal change in the month of August 2015, one month before the CGT suspension announcement. This outcome was caused by already growing expectation amongst shareholders that Government would suspend CGT on marketable securities. Finance Bill 2015 had suspended CGT in June 2015 but had proposed a withholding tax of 0.3% on the capital gain realised to be implemented with effect from 1st January 2016. The study findings were consistent with those of Karinga (2015) and Eichfelder and Lau (2014). Karinga (2015) indicated there was significant change in stock performance after CGT announcement, while that done by Eichfelder and Lau (2014) indicated a temporary strong increase in trading volumes and asset prices.

5. Conclusion

From the above findings, conclusions can be made that capital gains tax has negative effect on foreign portfolio investment at the NSE because the tax levied on sale of shares reduces the profits made by an investor. Therefore, investors will opt to reduce the investment and channel the funds to a different market or type of investment. Investors who opt to hold the shares may require higher price for the shares at the time of disposing in order to get compensation for the expected erosion of the earnings by the tax to be paid. This behaviour of investors depends on their level of knowledge and tax awareness as was observed by Eichfelder and Lau (2014

5.1 Recommendations

To the government, study recommends the stakeholders should be consulted before implementation of a tax law so as to minimize challenges and/or resistance during implementation. This is because capital gains tax experienced operational challenges at the Nairobi Securities Exchange since the stock brokers did not know how to effectively implement the tax law.

To the Nairobi Securities Exchange, the study recommends that they should monitor taxes and other costs that reduce investment returns at the securities exchange.

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