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

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## DECLARATION

I understand that plagiarism is an offence and I therefore declare that this project is my original work and has not been presented to any other institution for any other award.

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**D61/MAC/20563/2014**

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# LIST OF ABBREVIATIONS AND ACRONYMS

**ANOVA**       **:** Analysis of variance

**CGT**         **:** Capital gain tax

**EPZ**         **:** Export processing zone

**IEBC**        **:** Independent electoral and boundary commission

**KASIB**       **:** Kenya association of stockbrokers and investment banks

**KRA**         **:** Kenya Revenue Authority

**OECD**        : Organization for economic co-operation and development

**PIRI**        **:** Prime international residential index

**REB**         **:** Real Estate Business

**UK**          **:** United Kingdom

**USA**         **:** United States of America

**VAT**         **:** Value Added Tax

# DEFINITION OF TERMS

**Capital allowances**  The amount which a business can deduct from the overall corporate, income tax or CGT on its profits or gains (Clark, Cebreiro, and Bohmer, 2007)

**Capital gains**  Profit that result from a sale of a capital asset, such as stock, bond or real estate, where the sale price exceeds the purchase price (O'sullivan, Arthur; Sheffrin, Steven 2003),

**Capital gains tax**  A tax chargeable on the gains that accrue to an individual or a company on or after 1st January, 2015 on the transfer of property situated in Kenya whether or not the property was acquired before 1st January, 2015 (Income Tax Act 2010)

**Capitalization effect**  A situation where capital gains taxes decrease demand for stocks or property in the property market as investor shy away from buying new property due to increased transaction cost associated with capital gain tax (Ricardo and Erosa 2007)

**Land**  The eighth Schedule of Income Tax Act (2010) defines land to include (a) buildings on land and anything attached to land or permanently fastened to anything attached to land (whether on or below the surface); (b) standing timber, trees, crops and other vegetation growing on land; and (c) land covered by water

**Lock-in**  A situation where capital gains taxation decrease supply of a property in a property market as the investor shy away from selling their property due to increased transaction costs associated with capital gain tax (Ricardo and Erosa 2007)

**Performance**  It can be entrenched in the efficiency, profitability, ability to maintain growth as well as positively adjusting to the demands of the environment to identify the opportunities and threats (Miller, Boehije and Dobins, 2013; Gao, 2010).

**Property**  In a case of an individual or a company, property is defined in Part I of the Eighth Schedule of Income Tax Act (2010) as a land situated in Kenya and any right or interest in or over that land.

**Real Estate Business**  Involves the construction, purchase, ownership, management, rental and/or sale of real estate with an aim of making profit.

**ABSTRACT**

The current study sought to establish the effect of capital gains tax on performance of real estate businesses in Mavoko Municipality, Machakos County. Capital gains tax was first introduced in Kenya in the year 1975 but suspended later in 1985 with an objective of spurring investment in real estate as well as in the securities market. The real estate property market has been booming since its suspension in 1985. However, after nearly 30 years of suspension by the Kenyan Parliament, Kenya Revenue Authority announced to reintroduce the tax back with an applicable rate of 5% of the net gain and become effective on 1$^{st}$ January 2015. The introduction of CGT in our tax system was met with a lot of opposition. One of the strongest arguments against the reintroduction of CGT was that it will affect the 'first time' and 'young' home-buyers on the decisions to resell their homes in order to buy bigger and better ones, particularly when such buyers have to take out mortgages to support the new purchase. 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. Coefficient of determination was used to measure the proportion of variance in the dependent variable that can be explained by independent variables. ANOVA, T- and F- tests were 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 were found to be having an insignificant negative relationship. A conclusion was therefore made that there exists a significant relationship between capital gains 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 them, their contribution to overall performance is insignificant.

<div align="center">**CHAPTER ONE**</div>

## 1.0 BACKGROUND OF THE STUDY

### 1.1 Introduction

This chapter covers the background of the study, statement of problem, objectives of the study, the scope of the study, limitations and delimitations, assumptions and the justification of the study.

### 1.1.1 Capital Gains Tax

Capital gain tax is not a new tax in Kenya. The tax was first introduced in Kenya in the year 1975 twelve years after independence after which it was suspended later in the year 1985 with an objective of encouraging investors to invest in real estate and the securities market. Studies shows that the objective of suspension was achieved since its suspension saw many investors invested more in real estate and stocks markets. For example, study by Masika, (2010) shows that since suspension of CGT, real estate property market has been booming due to among other factors increased availability of financing through mortgages. Also, data by Property Index and Management Firm Hass Consult (2012) show that the average value of a property developed on eighth acre in Nairobi, in the year 2000 was Ksh 7 million but in the year 2007, the price of the same property was at an average of Ksh 24 million. This shows that property values have increased by 3.38 times since 2000. Masika (2010) summed all these by stating 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.

Though CGT is a new tax in many countries, considerable number of studies has been done by researchers locally, regionally and even globally. However, the area of CGT remains poorly area in Kenya. Some few scholars who have dedicated their time to research in this area include Mburu (2013), Al-Kuwari (2009).

Globally, a study carried out by Hungerford (2010) established that, capital gains tax has had an influence in the performance of companies registered in the stock exchange market by having their anticipated profit margins fall, their assets pace

reducing, strained financial risks management, dropped profits, long holding of assets due to future speculations that led to more losses and many more.

Regionally, study done by Organization for Economic Co-operation and Development (OECD), in 2013 suggested that capital gains tax has not only been a source of income for the government in African counties like South Africa, Nigeria and Ghana but has been a source of motivation for a number of companies to invest higher and smartly for improved profits. This tax is well pronounced in Uganda where it has been in operation for a while though they are at a higher rate than that in Kenya. A report by the Daily Monitor in Uganda for example shows that, the Income Tax Amendment Bill 2010 was finally out and as they all expected it contained a lot of new tax provisions that prescribe how petroleum operations were to be taxed in Uganda. The Bill specifically explained in detail how the income of companies involved in the petroleum operations in Uganda could be taxed, the rates of tax that will apply to such income as well as prescribing the manner in which the tax is to be paid.

According to Klemm and Van Parys (2012) in their paper Empirical evidence on the effects of tax incentives in Uganda, Ghana, Ethiopia and South Africa argued that, small companies that don't have political influence in Uganda have been negatively affected financially by income tax gains. Citing evidence of five companies, they argue that the companies for almost one year for example lost up to five employees on average because they couldn't afford their wages since they went to taxes, their expenses on financial innovations increased (financial management/financial management structures balance), their capital bases decreased. Borrowing capacities went down, speculations reigned and final losses incurred etc.

Ricardo and Erosa (2007) argue that the impact of CGT can be measured through the lock in effect and capitalization effect. They argued that "Lock-in," occurs when taxpayers delay selling investments that have large unrealized gains in order to avoid the immediate tax hit. Lock-in effect concept views the impact of capital gain taxes from the perspective of the seller and it measures how the CGT affects the supply of property in property market. Lock in effect is measured by the reduction in the supply of some property in the market. Capital gains lock-in reduces market efficiency.

On the other hand, capitalization effect concept analyzes the capital gain tax effect from the perspective of the buyers. It discusses the impact of capital gain tax on demand for property. Dai, Maydew, Douglas and Zhang (2008) argue that where capital gain taxes are charged, people buying property will negotiate to acquire them at a lower price to be compensated for the future tax liability. This effect is known as the capitalization effect. It is measured using the reduction in the demand for property in the property market.

### 1.1.2 Performance

Performance can be entrenched in the efficiency, profitability, ability to maintain growth as well as positively adjusting to the demands of the environment to identify the opportunities and threats (Miller, Boehije and Dobins, 2013; Gao, 2010). According to Combs, Crook and Shook, (2005), dimensions of financial performance are: profitability growth, and market worth profitability measures a firm's past ability to generate returns (Glick, Washburn & Miller2005). According to Raheman, Afza, Qayyum, and Bodla (2010), every business is most concerned with its profitability; they defined profitability as the ability to make profit from all the business activities of an organization, company, firm, or an enterprise.

### 1.1.3 Real Estate Business

Kenyan real estate property covers all property categories including single and multi-family residential dwellings, commercial and agricultural land, office space, go-dawns and warehouses, 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). Kenya Country Report (2010) records that the government in consultation with other stakeholders has continued to formulate various policies to guide and enhance access to housing and thereby increase the quantity of real estate available with considerable degree of success. This has given way to a more pragmatic strategy of enabling other actors to get involved in this sector. The Knight Frank's 2011 Prime International Residential Index (PIRI), which monitors price changes across the world's top-end

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property markets shows that Kenya's luxury real estate saw the greatest price increase globally. The value of Nairobi's prime real estate grew by 25% while at the Kenyan coast it went up by 20% outdoing other major cities like Miami (19.1%), London (12.1%), Moscow (9.8%), New York (3.1%), Shanghai (-3.4%) and Singapore (4.7%).

This high demand for housing coupled with high returns has led to emergence of real estate businesses in Kenya. Real estate business is the profession of buying, selling, or renting land, buildings, or housing.

### 1.1.4 Mavoko Municipality

The study focused on Mavoko Municipality which is located in Machakos County. The Municipality forms the current Mavoko Constituency (IEBC, 2011). According to daily nation (Thursday June 18 2015) had you bought a house in Athi River three years ago, the cost would have been about Sh3.9 million which now cost you a staggering Sh18.4 million. This means that cost for a four-bedroom bungalow sitting on a quarter-acre piece of land in 2011 was sh. 3.9 million and the value exponentially increased to Sh18.4 million by 2015. This is a depiction of how things have changed for the town that is in Machakos County.

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. Other factors include the topography and proximity of the property to the CBD because Buyers are looking for place which is close to town where they can commute. At the same time, they want beautiful scenery. Facilities like institutions and industries coupled with planning regulations in such areas are also contributing to highly priced properties.

This emergence of real estate business in Mavoko made it an ideal place for the current study to be carried out in. The current study therefore sought to establish the relationship between capital gains tax and performance of real estate businesses in Mavoko Municipality, Machakos County.

## 1.2 Statement of the Problem

In Kenya, CGT was first introduced in the year 1975. However, in the year 1985, the tax was suspended where the major objective for the suspension was to spur investment in real estate as well as in the securities market. Since the suspension of CGT, the 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 by the Kenyan Parliament as an incentive to grow real estate sector and capital markets, KRA announced to reintroduce the tax back by use of the Finance Act No. 16 of 2014 through Kenya Gazette Supplement No. 141 on 19th September 2014 with an applicable rate of 5% of the net gain and become effective on 1st January 2015. The introduction of CGT in our tax system has been met with a lot of opposition. According to Nairobi Business Monthly (1st April 2016), CGT was resisted not only by the directly affected stakeholders such as Kenya Association of Stockbrokers and Investment Banks (KASIB) and medium income earners but also by low income earners, people unlikely to pay it, but who thought that if someday they might need to, then they would rather not support its introduction. One of the strongest arguments against the reintroduction of CGT was that it will affect the 'first time' and 'young' home-buyers on the decisions to resell their homes in order to buy bigger and better ones, particularly when such buyers have to take out mortgages to support the new purchase.

According to Kenya Insight Report (KIR) on real estate prices by Macharia, (2018) 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. The report further

observed that due to prevailing market conditions, introduction of CGT and high capital values have resulted in low transaction volumes of real estate property. With this decline in transaction volumes, there is 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. The current study therefore sought to establish the relationship between capital gains tax and performance of real estate businesses in Mavoko Municipality, Machakos County.

## 1.3 Objectives of the Study

### 1.3.1 General Objectives
The general objective of the current study was to establish the relationship between capital gains tax and performance of real estate business in Mavoko Municipality, Machakos County

### 1.3.2 Specific Objectives
The specific objectives of the study were;

i.     To determine the effect of capital gains on performance of real estate business in Mavoko Municipality, Machakos County.
ii.    To establish the effect of capital allowances on performance of real estate business in Mavoko Municipality, Machakos County.
iii.   To find out the relationship between lock in effect and performance of real estate business in Mavoko Municipality, Machakos County.
iv.    To determine the relationship between capitalization and performance of real estate business in Mavoko Municipality, Machakos County.

## 1.4 Study Question
The current study sought to answer the following questions

i.     What is the effect of capital gains on performance of real estate business in Mavoko Municipality, Machakos County?
ii.    What is the effect of capital allowances on performance of real estate business in Mavoko Municipality, Machakos County?

iii.    What is the relationship between lock in effect and performance of real estate business in Mavoko Municipality, Machakos County?

iv.    What is the relationship between capitalization and performance of real estate business in Mavoko Municipality, Machakos County?

## 1.5 Justification of the Study

To the investors who might want to start the real estate businesses in Mavoko, the findings can act as a guide to know how capital gains tax will affect their businesses. On the side of academia, researchers will find this study useful for further research. To the already existing real estate businesses, the managers of those businesses will use the findings of this study to know when to buy or sell real estate. To the tax authorities, they will use the findings in making decisions concerning how much capital gain tax to charge. The findings will also be useful to the buyers since they will be able to know when to buy a new estate property.

## 1.6 Limitations and Delimitations 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.

## 1.7 Assumption of the Study

The research used real estate businesses which are limited liability companies. It was assumed that limited liability companies have adequate employee who are trained or have knowledge on accounting for capital gain tax. This assumption was necessary since this tax is a new tax in Kenya which many people may not be conversant on how to account for it. It was also assumed that the Real Estate Businesses under investigation were registered with Kenya Revenue Authority for the purpose of taxation. According to Income Tax Act (ITA) (2010) all businesses with a turn over Ksh 5 million for the past 12 months should be registered with it for the purpose of paying tax. Failure to register comes with a fine of utmost Kshs.20000 or imprisonment for a term not exceeding six months or both. For the registered firms, proper records of its transactions must be maintained failure to which a default penalty of between Kshs.10000 to Kshs.200000 is charged. In case of fraudulent accounting a fine not exceeding Kshs.400000 or double the tax evaded (whichever is higher) or imprisonment for a term not exceeding three years or both is given as a penalty. This assumption was important because the study required the use of data on the payment of Capital Gain Tax by the Real Estate Businesses.

## 1.8 Scope of the Study

The study was done in Mavoko municipality and it was confined to real estate businesses operating in Mavoko Municipality and which are registered under the Department of Transport, Roads, Public Works and Housing of Machakos County Government (Machakos County Government, 2018). Due to nature of required information, the study focused on those Real Estate Businesses which are limited liability companies. Focus was on the entire departments of each real estate businesses. It also included those in management position as they are the financial controllers in the companies. Directors were available were also sampled out to be used as respondents.

**CHAPTER TWO**

**2.0 LITERATURE REVIEW**

**2.1 Introduction**

This chapter presents the literature review on theories and empirical review linking CGT to performance. Theoretical and empirical review helps in getting in-depth understanding of the current body of knowledge on the research topic and understanding studies that have been done on the same area by other researchers and the recommendations therein. Conceptual frame work based on those theories, literature review and objectives was then developed.

**2.2 Theoretical Review**

The theoretical review of this study was based on the following theories that support the concept of capital gain tax and performance of real estate businesses in Mavoko Municipality, Machakos County.

**2.2.1 Benefit Theory of Taxation**

According to Neumark and McLure (2013), the benefit principle is a concept in the theory of taxation from public finance. It bases taxes to be paid for public-goods expenditures on a politically-revealed willingness to pay for benefits received. The principle is sometimes likened to the function of prices in allocating private goods.

In its use for assessing the efficiency of taxes and appraising fiscal policy, the benefit approach was initially developed by Wicksell (1896) and Lindahl (1919), two economists of the Stockholm School. Wicksell's near-unanimity formulation of the principle was premised on a just income distribution. The approach was extended in the work of Musgrave (1959). According to Musgrave and Musgrave, (1973) it is applied to such subjects as tax progressivity, corporation taxes, and taxes on property or wealth.

The benefit principle takes a market-oriented approach to taxation and is based on the following assumptions: taxpayers like consumers, would "pay for what they get"; Taxes are more akin to prices that people would pay for government services; Consumer sovereignty; efficient allocation of limited resources and that taxpayers would have a better understanding of the costs of public goods.

The primary criticism given for limiting the scope of the benefit principle is that when information about marginal benefits is available only from the individuals themselves, they tend to under report their valuation for a particular good, this gives rise to the preference revelation problem. Each individual can lower his tax cost by under reporting his benefits derived from the public good or service. One solution would be to implement tax choice. If taxpayers had to pay taxes anyway, but could choose where their taxes went (without the possibility of secret rebates or similar), then they would have no incentive to hide their true preferences. Dempsey (1960), argues that the value of property depends on its location. Thus the value of property in areas where the government has invested heavily in infrastructure and other social amenities is likely to be higher that areas where the government has invested less.

Real estates in developed areas are likely to attract high capital gains within a short time period compared to those in remote area. For example, an article in the Daily Nation dated (Thursday June 18 2015) observed that the cost of buying a house in Athi River three years ago, was about Ksh 3.9 million but as at 2015 it was costing Ksh18.4 million. Thus the cost for a four-bedroom bungalow sitting on a quarter-acre piece of land in 2011 was sh. 3.9 million and the value exponentially increased to Sh18.4 million by 2015. This depicts how things have changed for the small town that is in Machakos County due to increased accessibility to the area and its proximity to the capital city Nairobi. Since the government has pumped more resources in developing infrastructures in this area, the Benefit Theory of Taxation requires that the land and real estate owners in this area pay higher Capital gain tax annually compared to those areas which have benefited less from government resource. However, when information about marginal benefits is available only real estate owners, they tend to under report their capital gains so as to lower their tax liability. This will mean they pay less than the benefit they get from the public revenue or resources. Paying less tax will lead to increased net profits and thus the managers of real estate businesses can rely on the information asymmetry to significantly reduce their tax obligations and improve their performance.

## 2.2.2 Agency Theory

The principal and agent theory emerged in the 1970s from the combined disciplines of economics and institutional theory. There is some contention as to who originated the theory, with theorists Ross and Mitnick claiming its authorship (Mitnick2006). The most cited reference to the theory, however, comes from Michael C. Jensen and William Meckling, (Michael and William 1976). The theory has come to extend well beyond economics or institutional studies to all contexts of information asymmetry, uncertainty and risk.

Agency problems exist between government agencies responsible for attracting investment and those responsible for the more generic business environment. Whilst investment-promotion agencies can play an important role in coordinating government activities to attract investment, they also often argue for incentives without taking account of the costs borne by the economy as a whole (Zee, Stotsky and Ley 2002).

Despite the lack of evidence to support the efficacy or efficiency of fiscal incentives, governments continue to offer them. Wells, Allen, Morisset and Pirnia (2001) argue that tax incentives offer an easy way to compensate for other government-created obstacles in the business environment. In other words, fiscal incentives respond to government failure as much as market failure. It is far harder, and takes far longer, to tackle the investment impediments themselves low skills base, regulatory and compliance cost than to put in place a grant or tax regime to help counterbalance these impediments. Although it is a second-best solution to provide a subsidy to counteract an existing distortion, this is what often happens in practice.

According to Allen and Morisset (2001) governments may legitimately feel that strict horizontal equity with government taxation and expenditure does not adequately address policy objectives and inherent market failures in certain sectors. The policy objectives might include; increasing investment to a specific region, which does not receive as much investment as it should, given the economic fundamentals because of information asymmetries.

Real estate businesses should search for this information which is mostly available with the government agencies responsible for taxation and use it to know area where there are capital allowances like investments deductions, wear and tear deduction and other tax incentives offered by the tax authorities. If equipped with such information, they can highly improve their performance by ensuring they get maximum Capital deductions from their Capital Gain Tax liability.

### 2.2.3 Transaction Cost Economics Theory

In both economics and corporate finance, transaction cost is a cost incurred in making any economic exchange, or in other words the cost of participating in a market (Cheung and Steven 1987). The concept of transaction cost was developed from the idea by Commons (1931) that transactions form the basis of an economic thinking. However much of the work is based on the work of Ronald Coase (1937), best known as the forefather of transaction cost theory. According to him, transaction costs arise when transactions are conducted through the market.

Transaction cost Economics theory is based on the following assumption that transaction costs depends on the frequency of transaction, specificity of the buyer and seller, uncertainty of the transaction, limited rationality and opportunistic behavior of the parties involved (Williamson 1981). Thus small and frequent transactions are costly than large and few transactions since most of transaction costs are fixed costs in nature. On the other hand, if the seller has more information about the market price of the property been transacted, there is likelihood that he will take the advantage of the information asymmetry to charge more price to the buyer.

A study conducted by Ricardo and Eros (2007), similar to a study conducted by Tahar, Soner and Touzi (2005) observed that capital gain taxes contributed a significant portion of transaction costs hence limiting investors to sell their securities. The increased transaction costs hindered sellers from selling the securities since they incurred the costs while transferring the properties to the buyers. Consequently, the seller obtained lower returns from the sale than they expected. In addition to increase in cost of transfer that contributes to lock in effect, Jones (2010) noted that the CGT also contributed to the increase in cost of portfolio rebalancing. Jones (2010) noted

that those who were holding securities were reluctant to sell them and buy other securities since they did not want to incur the high cost of portfolio rebalancing caused by CGT. Therefore, CGT leads to both lock in effect and capitalization effect where the lock in effect reduces the supply of property in the market while capitalization effect reduces the demand of the same property in the property market.

Real estate businesses should balance between buying and selling few units of properties frequently and selling or buying larger units of properties less frequently. Buying and selling fewer units frequently will lead to increased unit costs since these costs like stamp duty are mostly fixed costs. However, making less frequent transactions will reduce the transaction costs involved leading to more profitability of the Real Estate Businesses.

### 2.2.4 Prospect Theory

The prospect theory proposed by Kahneman and Tversky (1979) and developed in 1992 is a cognitive psychology theory that tries to describe how people make choices between alternatives involving risks, and make decisions involving uncertainty. According to this theory, individual make choices and decisions based on some potential benefits and risks rather that the final outcomes of the decision. This theory is descriptive theory nature and explains how people make investment decisions based on expected utility maximization in future. Prospects theory explains economic behaviors like disposition effect, risk averseness and risk seeking. According to Kahneman and Tversky (1979), economic agents frame an outcome or transaction subjectively in their mind which in return affects the utility they expect or get.

Prospects theory is based on assumption that outcomes of a decision by a decision maker are ordered according to certain rules used to form judgments and make decisions. These rules are mental shortcuts involving focus on one complex problem and totally ignoring the other problems (Baron 2000). This can work well under some circumstances but mostly leads to systematic deviations from logic and probability. Also, the theory assumes that an individual behaves as if he could calculate the utility of a product based on some potential outcomes and their respective probabilities. The individual then chooses the alternative with the highest utility.

Prospects theory suffers several limitations and criticisms. The original form prospect theory led to what is known as first-order stochastic dominance. This is a situation where probability distribution over possible outcome can be ranked as superior than that of another decision maker. Another critic came from the field of psychology who argues that prospect theory cannot offer psychological explanation for the process stated in the theory as a descriptive model (Staddon 2017). The field of psychology further argues that the factors important to decision making process such as emotion have not been included in the model (Newell, Lagnado, shanks 2017)

Buying or selling a real estate property in situations where capital gain tax brings in capitalization effect and lock in effect can be viewed as a decision involving choice, where a buyer or seller makes a decision that minimizes risks in case of risk averse investors. For the case of risk seekers, they will go for that risk which has more risks with promising long-term returns in future. Thus during capitalization effect, a decision on whether to buy real estate property will depend on whether the buyer is risk averse or a risk taker. Risk takers are likely to make a decision to buy real estate property at a time when there is capitalization effect while buyers who are risk averse will wait until the situation is over. In case risk taker, they will sell their real estate property at a time when there is lock in effect while those who are risk averse will sell their estate property when there is no lock in effect.

## 2.3 Empirical Reviews

The literature will be reviewed in relation to the concept of capital gains, capital allowances, lock in effect and capitalization effect each of which will tries to review empirical research done on this area of capital gain tax.

### 2.3.1 Capital Gains and Performance of Real Estate Businesses

Omboi (2011) conducted a study on the factors influencing real estate property prices in Meru Municipality. The variables used in this study are income of real estate investors, location of a real estate property, demand and realtors and brokers. Income from real estate property was found to be the key factor influencing real estate property prices in Meru Municipality accounting for more than 70% of the changes in property prices other factors remaining constant. Demand for real estates in Meru was found to be the second most important factor influencing real estate prices as it

contributed to 20% of the changes in prices. 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.

Hou (2010) conducted a study in two cities in China (Beijing and Shanghai) to determine if there was housing price bubble. He showed that between 2005 and 2008 Beijing appeared to have been on the way of forming a housing price bubble. In Shanghai, Hou found that a 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). The 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 it went up by 20% outdoing 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.

The two studies by Hou (2010) and Omboi (2011) agrees that increase in capital gains will lead to performance of real estate business. Omboi (2011) concluded that the performance of real estates in Meru depends on the income derived from the said real estate while Hou (2010) concluded that the three stages were characterized by bubble effect and rapid real estate growth.

## 2.3.2 Capital Allowances and Performance of Real Estate Businesses

Governments through capital allowances attempt to influence physical and financial capital. The Income Tax Act provides for various tax incentives through capital deductions. The government has allowed a claim of 150% for companies who invest outside the 3 cities and incur expenditures of more than 200 million. Capital allowances are usually in form of Investment Deduction (ID), wear and tear allowances (WTA), among others. Companies are currently claiming ID at 100% while those that invest outside the 3 cities for expenditures of Kshs200 million and over claim at 150%. WTA is calculated on machinery depending on the class of machinery (ITA, 2010). 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. Positive impact of various attractive incentives extended to the EPZs include increased foreign exchange earnings for the state, 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) focused on corporate tax incentives as well as firm performance. This study used data that was obtained from confidential tax return data that was 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.

The review of literature on Tax incentives and performance by Njeru and Ndimitu (2015) and Maffini and Xing (2015) also came up two conflicting results. Njeru and Ndimitu (2015) established that the influence of tax incentives on investments in EPZ was insignificant while Devereux, Maffini and Xing (2015) findings indicated that there is evidence that corporate tax incentives affected the external leverage of both domestic and multinational companies.

### 2.3.3 Lock in Effect and Performance of Real Estate Businesses

Lock in Effect determines investment in securities from the point of view of the sellers (Ricardo & Eros, 2007). 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.

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. It is expected that they will have same effect to any property dealt with in the security/property market.

## 2.3.4 Capitalization Effect and Performance of Real Estate Businesses

This theory views the impacts of CGT from the perspective of the buyer (Dai, Maydew, Shackelford, and Zhang (2010)). According to this theory, people buying securities will negotiate to acquire the securities at a lower price to be compensated for the future tax liability. Therefore, buyers push for lower process. On the hand, sellers are pushing for higher process to be compensated for the high cost of transfer and the subsequent costs of portfolio rebalancing.

Capitalization has great influence on demand for securities. Capitalization effect influences the intention of buyers to buy property (Sialm, 2009). 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.

In Kenya, Marangu (2011) conducted a qualitative study to explore the introduction of wealth tax transfer in Kenya as one of the means to lead to equal distribution of wealth. In his study Marangu (2011) interviewed 50 Kenyans on their take on introduction of CGT. He also compared the Kenyan tax system and the tax system in other countries such as Japan. The results from the study indicated that the Kenya government could earn more income from the transfer of property. The findings from this study made the researcher to conclude that the introduction of CGT would lead to more with instruction of CGT. However, with the increase in transaction costs, the buyers may not be willing to acquire property leading to low demand for the estate property. This on the other hand could lead to low government revenue in addition to low performance of estate businesses.

## 2.4 Conceptual Framework

According to Kombo and Tromp (2009) conceptual framework is a set of broad ideas and principles taken from relevant fields of enquiry and used to structure a subsequent presentation. Creswell, (2003) pointed out that Conceptual framework helps the researcher to define the concept, map the conceptual scope, systematize relations among concepts and identify gaps in literature. It contains a scheme of both independent variable and dependent variable which the researcher operationalizes in order to achieve his set objectives. Conceptual framework comprises the Independent variable also known as the explanatory variable and which is the presumed cause of the changes of the dependent variable and the dependent variable also known called criterion or predictor variable which the researcher wishes to explain (Kothari 2004).

**CAPITAL GAIN**
- Net gain
- Value of property
- Real estate sales

**CAPITAL ALLOWANCES**
- Form of CA
- Rate of CA
- Availability of CA

**LOCK IN EFFECT**
- Supply of the real estates
- Sales of real estates
- Transaction cost

**CAPITALIZATION EFFECT**
- Transaction cost
- Demand for real estate
- Purchases of real estate

**PERFORMANCE**
- Profitability
- Operational efficiency
- Growth

**Independent Variable**

**Dependent Variable**

**Figure 2.1:** Conceptual Framework

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Capital gain was the first component of capital gain tax. It was measured using the net gain, value of property and sales of real estates. The second component of capital gain was capital allowances. The indicators of capital allowances include the rate of capital allowance, frequency of capital allowance and its availability. The third component of capital gain tax was lock in effect. Lock in effect was measured using the supply of the real estates, sales of real estates and the transaction costs. The last component was capitalization effect whose indicators were demand, estates turnover and transaction costs. The dependent variable was performance and its indicators were profitability, operational efficiency and growth of real estate businesses.

## 2.5 Research gap

The government announced reintroduced of CGT recently after a suspension of close to 30 years using the Finance Act No. 16 of 2014 through Kenya Gazette Supplement No. 141 on 19th September 2014 with an applicable rate of 5% of the net gain and become effective on 1st January 2015 but was not implemented. Since its reintroduction, a couple of studies have been carried out to determine its effect 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.

<center>CHAPTER THREE</center>

## 3.0 RESEARCH METHODOLOGY

### 3.1 Introduction

Research methodology is the analysis of the methods, principles and rules that are applied by the researcher while carrying out a research. This chapter comprises of research design, target population, data collection methods and tools, data analysis and ethical considerations.

### 3.2 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. Kothari (2004) states that research design is the arrangement of the conditions for collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy in procedure. This study used a descriptive design. 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.

### 3.3 Target Population of the Study

According to Cooper and Schindler (2011) population is the total collection of elements about which one wish to make some inferences. The target population should have some observable characteristics, to which the study intends to generalize the results (Mugenda and Mugenda 2003). 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.

### 3.4 Sampling Techniques and Sample Size

According to Kombo and tromp (2006), sample should be at least 30 elements so as to obtain favourable results. Also, Mugenda and Mugenda, (2003) recommends that

10% of the population is an adequate sample in social sciences. The researcher used census method where the employees were stratified into strata based on the position held in the company. Each element in each stratum was used giving a sample size of 143 respondents. These strata include directors, managers, accountants, sales persons and receptionists. The sample of 143 respondents is shown in table 3.1 below.

**Table 3.1 Sampling Techniques and Sample Size**

| Position | Sample size |
|----------|-------------|
| Directors | 5 |
| Managers | 31 |
| Accountants | 65 |
| Sales persons | 22 |
| Receptionists | 20 |
| **Total** | **143** |

**Source:** Author (2019)

### 3.5 Data Collection Instrument

This study used primary data. According to Chandran, (2004) primary data is first-hand information received from a respondent. Open and closed ended structured self-administered questionnaires with a likert scale was used to collect the primary data. According to Cooper and Schindler (2011), self-administered questionnaires are used in descriptive studies because they cost less. Also, the respondent fills the questionnaire without intervention of the researcher and that reduces the influence of the researcher on the responses given by the respondent. The questionnaire was divided into parts A to F. Each part assesses the information for a specific variable. Part A is background information which tries to explain the nature of the REBs under study; part B on items on performance of each REB; part C is on capital gains and performance of real estate business; part D is on capital allowances and performance of REBs; part E is on lock in effect and performance of REBs while part F is on

capitalization effect and performance of REBs. The questionnaire used is shown in appendix III.

### 3.5.1 Data Collection Procedure

Questionnaires were presented to each of the REB targeting the directors, managers, accountants, sales persons and receptionists selected for the study. Each of the respondents was allowed adequate time to fill the questionnaire before the researcher collected them to analyze the data.

### 3.6 Pilot study

According to Hulley (2007), a pilot study, pilot project, pilot test, or pilot experiment is a small scale preliminary study conducted in order to evaluate feasibility, time, cost, adverse events, and improve upon the study design prior to performance of a full-scale research project. The pilot study was done to ascertain the reliability and validity of research instrument.

### 3.6.1 Reliability of the research instrument

According to McMillan & Schumacher, (2010) reliability of research instruments means the repeatability, stability or internal consistency of a questionnaire. Cronbach's alpha was used to test the reliability of the measures in the questionnaire. According to Ritter (2010), the theoretical value of alpha varies from 0 to 1, since it is the ratio of two variances and the variance in the denominator is always at least as large as the variance in the numerator. Bryman (2008) suggests that where Cronbach's alpha is used for reliability test, as a rule of thumb, Cronbach's alpha values for items included in a study should not be lower than 0.70. The items that did not reach the threshold were either re-written or dropped from the questionnaires.

### 3.6.2 Validity of Research Instrument

Validity of research instruments refers to whether the questionnaire is measuring what it purports to measure (Bryman, 2008). To ascertain the validity of research instrument, a pilot study was conducted in neighboring Makueni County where 10% of the total sample was used giving a total of 14 respondents. The validity of the questionnaire was then enhanced after a pilot test.

## 3.7 Data Analysis

Data analysis involves looking through collected data and editing it for errors (Kinoti, 1998) where the errors in data may have occurred due to failing to record, wrong entry, ineligibility of words or numbers in recordings, jammed recording instruments, outliers and miscalculations (Gay, 1992).

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 will be used to analyze the data. Similar software was used by Saleem and Rehman (2011), Afza and Nazir (2008), Radhika and Azhagarah (2012), Kaddumi and Ramadan (2012). The summary statistics of the mean, median, kurtosis, standard deviation, minimum and maximum of all the variables for both dependent and independent variables were constructed and correlation matrix of the independent variables created. Correlation Coefficient (r) was used to determine and measure the strength and direction of the relationship between the dependent variable and each of the independent variables while coefficient of determination ($r^2$) was used to measure the proportion of variance in the dependent variable that can be explained by independent variables.

ANOVA, T- and F- tests were used to test the significance of the model in measuring the relationship between capital gains tax and performance at 95% confidence level and 5% significant level. This value of 95% confidence level and 5% significant was suggested by Zar (1984) who suggested other confidence levels as 90% and 99%. If the significant number was found to be less than the critical value (p) set and the conclusion was that the model is significant in explaining the relationship.

## 3.7.1 Regression Model

The analytical model for this study is 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

$X_3$ represents the lock in effect due to CGT

$X_4$ represents the capitalization effect due to CGT

$\beta_0$ 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 $\varepsilon$ 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.

Hosmer and Stanley (2000) emphasize that regression models have become an integral component of any data analysis concerned with describing the relationship between a response variable and the explanatory variables. In a standard multiple regression analysis all the independent variables are entered into the regression equation at once because there are no control variables (Cameron, 2005).

### 3.8 Ethical Considerations
The researcher got a letter from the university for purpose of data collection. The data collected was handled with confidentiality and it was not to be altered to meet any hidden or personal interest. The researcher also facilitated informed consent so as to let the respondents know what the research will be about where the respondents were reassured that the study was purely for academic purposes.

## 4.0 RESULTS

### 4.1. Introduction

The chapter is a descriptive analysis that consists of evaluating data reliability and presenting the summary statistics for research whose objective was to establish the relationship between CGT and performance of real estate businesses in Mavoko Municipality.

### 4.2 Pilot Testing Results

A pilot test was done to ascertain the dependability of the research instrument. A Cronbach's alpha coefficient was used to assess the instrument's reliability. That is to ascertain the repeatability, stability or internal consistency of a questionnaire used in the research. The following results as recorded in table 4.1 were obtained.

**Table 4.1:** Reliability of Research Instrument

| Variable | Cronbach's Alpha based on Standardized Items | Number of Items |
|---|---|---|
| Performance | .838 | 5 |
| Capital gains | .810 | 5 |
| Capital allowances | .846 | 5 |
| Lock-in effect | .814 | 5 |
| Capitalization effect | .812 | 5 |

**Source: Research data (2019)**

The table above shows that the Cronbach's alpha coefficient for the five items, which include performance, capital gains, capital allowances, lock-in effect, and capitalization effect yielded Cronbach's alpha coefficients of 0.810, 0.846, 0.814 and 0.812. Each of the Cronbach's alpha coefficients is above 0.7, indicating that the instrument is reliable.

### 4.3 Response Rate

A total of 143 questionnaires were administered to the sampled real estate business employees consisting of the directors, managers, accountants, sales persons and receptionists, out of which 113 were responded to and returned and hence a response rate of 79%. The respondents were required to state the position held in the organization. Table 4.2 shows the results.

**Table 4.2:** Participant's position in the organization

| Question | Expected responses | Percentage |
|---|---|---|
| What is your position in the organization | Director | 4.4 |
| | Manager | 22.1 |
| | Accountant | 52.2 |
| | Sales person | 17.7 |
| | Receptionist | 3.6 |

**Source: Research data (2019)**

Among the respondents who filled and returned the questionnaire, 4.4 per cent were directors, 22.1 percent were managers, 52.2 per cent were accountants, 17.7 per cent were sales people while 3.6 per cent were receptionists. This shows that all directors selected to be part of the sample respondent, 80.6% of manager respondent, 90.7 % of the accountant respondent with 90.9% and 20% of the Sales person and receptionist respectively responded. Response was best among the directors and worst among the receptionist. This could be attributed to the fact that managers have more knowledge on the things to do with CGT as opposed to the receptionist who may know very little about accounting and CGT due to nature of the two activities. Future studies should concentrate on directors and other people who have more knowledge in accounting and taxation so as to improve on the response rate and quality of the responses.

### 4.4 Nature of Business

The Participants were also required to identify nature of their business by stating whether they buy and rent, build and sell or buy and sell. The results obtained were summarized in table 4.3 shown below.

**Table 4.3: The nature of business**

| Question | Expected responses | Percentage |
|---|---|---|
| What is nature of your business | Buying and renting | 17.8 |
| | Building and Selling | 57.8 |
| | Buying and Selling | 24.4 |

**Source: Research data (2019)**

Among those who responded, 17.8% of stated that their type of business was buying and renting, 57.8% of respondents indicated that their nature of business was building and selling, and 24.4% of respondents reported that their nature of business was buying and selling. From the results, most of the real estate businesses deal with building and selling of real estate property. This explains why currently there is a lot of real estate coming up in Mavoko like the green park real estate in Athi River among others. Many people are rushing to have a home in Athi River, but since they don't have time to buy land and build, they choose to buy already constructed houses or a developed piece of land.

## 4.5 Business Performance Indicators

The Participants were also required to state their business performance indicators. They were supposed to state whether they use profitability of business, operational efficiency of business, growth of real estate business or level of investment in real estate business as their business indicators. The results were recorded in table 4.4 below.

**Table 4.4: Business performance indicators**

| Question | Expected responses | Percentage |
|---|---|---|
| What is the major indicator of performance in your business? | Profitability of Business | 51.1 |
| | Operational efficiency of business | 6.7 |
| | Growth of real estate business | 26.7 |
| | Level of investment in real estate business | 15.6 |

**Source: Research data (2019)**

The table above shows indicators of business performance as identified by the participants. Out of 113 respondents, 51.1% of respondents indicated that the profitability of business determined their business performance and 6.7% of the participants responded that the operational efficiency of their business determined their performance. Moreover, 26.7% of the respondents stated that the growth of real estate business determined their performance, and 15.6% participants indicated that the level of investment in real estate business determined their business performance. From these findings, most real estate businesses use financial indicators as their test and measure of performance. This explains why most of the real estates have exaggerated prices as the owners try to make as much profit as possible.

## 4.6 Independent Variable Indicators

This section presents the results on how independent variable affects the dependent variable. The findings are derived from questions from the questionnaires where the respondents were required to state how the independent variable affects the dependent variable. The findings for each response were given as percentage of total responses.

## 4.6.1 Capital Gains

The first independent variable was capital gains and the researcher sought to determine the effect of capital gains on performance of real estate businesses in Mavoko Municipality, Machakos County. The findings based on responses from 113 respondents were recorded in table 4.5 below.

**Table 4.5:** Capital gain

| Question | Expected Response | Percentage |
|---|---|---|
| How do capital gains | Increases the profitability | 51.1 |
| affect the performance | Increases the operational efficiency | 17.8 |
| of your business? | Encourages growth of the business | 22.2 |
| | Increases investment in real estate business | 8.9 |

**Source: Research data (2019)**

The participants explained how capital gain affects their businesses' performance. Among those who filled and returned the questionnaires, 51.1% of the respondents indicated that capital gains increases the profitability of their businesses and 17.8% of the participants indicated that capital gains increases the operational efficiency of their businesses. Also, 22.2% of the participants indicated that capital gains encourages the growth of the businesses, while 8.9% of the respondents clarified that capital gains increases investment in real estate business.

Just like in subsection 4.5 above where the respondents were required to state their main indicator of performance, the findings in this sections supports the idea that most real estate businesses use profitability as their measure of performance.

### 4.6.2 Capital Allowances

The second independent variable was capital allowances and the researcher sought to determine the effect of capital allowances on performance of real estate businesses in Mavoko Municipality, Machakos County. The findings based on responses from 113 respondents were recorded in table 4.6 below.

**Table 4.6: Capital allowance**

| Statement | Expected Response | Percentage |
|---|---|---|
| How do capital allowances affect the performance of your business? | Increases the profitability of business | 68.9 |
| | Increases the operational efficiency of business | 11.1 |
| | Encourages growth of business | 4.4 |
| | Encourages investment in real estate business | 15.6 |

**Source: Research data (2019)**

The respondents clarified how capital allowances affect their businesses' performance. Among the 113 respondents who filled and returned the questionnaires, 68.9% of them indicated that capital allowances increases the profitability of their

businesses and 11.1% of the respondents stated that capital allowances increased the operational efficiency of their businesses. Besides, 4.4 % of the respondents indicated that capital allowances encourage the growth of their businesses while 15.6% of the participants explained that capital allowances encourages investment in real estate businesses. From these findings, the highest percentage of respondents indicated that capital allowances affect the profitability of the businesses supporting the idea that financial indicators are the major determinant of performance in real estate businesses.

### 4.6.3 Lock-in Effect

The third independent variable was lock in effect and the researcher sought to determine the relationship between lock in effect and performance of real estate businesses in Mavoko Municipality, Machakos County. The findings based on responses from 113 respondents were recorded in table 4.7 below.

**Table 4.7:** Lock-in Effect

| Statement | Expected Response | Percentage |
|---|---|---|
| How do Lock-in | Reduces profitability of business | 37.8 |
| effect affect the | Decreases operational efficiency of business | 20 |
| performance of | Reduces growth of business | 26.7 |
| your business? | discourages investment in real estate business | 15.6 |

**Source: Research data (2019)**

The respondents explained how lock-in effect affects their business performance. Among those who responded, 37.8% of participants indicated that lock-in effect reduces the profitability of business while 20% of the respondents explained that lock-in effect decreases the operational efficiency of the business. Moreover, 26.7% of the respondents stated that lock-in effect reduces business growth and 15.6% of the participants indicated that lock-in effect discourages investment in real estate business.

These responses indicate that in an effort to maximize profits, most real estate businesses use profitability as a measure of how lock in effect has affected their performance. They rarely use level of investment as a measure of performance as it attracted least responses.

### 4.6.4 Capitalization Effects and Performance

The fourth independent variable was capitalization effect where the researcher sought to determine how performance is affected by capitalization-effect. The findings based on responses from 113 respondents were recorded in table 4.8 below.

**Table 4.8:** Capitalization-effect

| Statement | Expected Response | Percentage |
|---|---|---|
| How do capitalization effects affect the performance of your business? | Reduces profitability of business | 42.2 |
| | Decreases operational efficiency of business | 20 |
| | Reduces growth of business | 44.4 |
| | Discourages investment in real estate business | 13.3 |

**Source: Research data (2019)**

Among the participants interviewed, 42.2 % of the respondents indicated that the capitalization effect reduces the business profitability while 20% of the participants identified that capitalization effect decreases the operational efficiency of the business. Furthermore, 44.4% of the participants reported that capitalization-effect reduces the business growth while 13.3% of the respondents identified that capitalization-effect discourages investment in real estate businesses.

Majority of respondents indicated that capitalization effects reduce growth of real estate businesses. These findings indicate that majority of real estate owners are concerned with how capitalization effect affects growth of real estate business.

### 4.7 Descriptive Statistics

This section presents the descriptive statistics on the effect of the independent variables on the dependent variable. The findings are derived from likert scale in the

questionnaires where the responses were supposed to indicate their level of agreement or otherwise with a given statement. The descriptive statistics are given in terms of means and standard deviations.

### 4.7.1 Capital Gains and Performance

The first objective sought to determine the effect of capital gains on performance of real estate business in Mavoko Municipality Machakos County. The responses based on 113 respondents were recorded in table 4.9 below

**Table 4.9:** Capital Gain and Performance

| Statement | Mean | Std. Dev. |
|---|---|---|
| Increased capital gains increases profitability in REBs | 4.00 | .741 |
| Level of capital gains determines size of real estate businesses | 3.75 | .988 |
| Increased capital gains encourages investments in REBs | 4.06 | .850 |
| Capital gains determines the level of investment in REBs | 4.08 | .947 |

**Source: Research data (2019)**

From table 4.9 above, the statement amount of capital gains determines the level of investment in REBs had the highest mean of 4.08 and a standard deviation of 0.741. Majority of the respondents agreed that investors' invest in real estate property depends on the capital gains of the property. The low standards deviation of 0.947 shows that variations in response were minimal and thus most responses were clustered between agrees and strongly agrees. The statement level of capital gains determines size of real estate business had lowest mean of 3.75 and the largest standard deviation of 0.988. The respondents indicated that they agreed with the statement since the mean is close to 4. However, the response has the highest standard deviation meaning the respondents had varying responses towards this question. From these findings, it is clear that most real estate owners sell or buy property based on capital gains expected after the sales.

### 4.7.2 Capital Allowances and Performance

The second objective sought to determine the effect of capital allowances on performance of real estate business in Mavoko Municipality Machakos County. The responses based on 113 respondents were recorded in table 4.10 below

**Table 4.10:** Capital allowance and performance

| Statement | Mean | Std. Dev. |
|---|---|---|
| Form of capital allowance has impact on performance of REBS | 4.23 | .962 |
| Information on available influence amount of CA claimed by REB | 3.98 | .727 |
| Capital allowance has impact on transaction costs in real estate business | 3.92 | 1.026 |
| Capital allowance has effect on tax liability of real estate businesses | 3.98 | 1.010 |

**Source: Research data (2019)**

From table 4.10 above, the statement form of capital allowance has impact on performance of real estate business had the highest mean of 4.23 and a standard deviation of 0.962 meaning majority of the respondents agreed that real estate property value depends on the capital allowance made against investment on the same property. The standards deviation of 0.962 shows that variations in response were minimal and thus most responses were clustered between agrees and strongly agrees. On the other hand, the statement capital allowance has impact on transaction costs in real estate business had lowest mean of 3.92 and the largest standard deviation of 1.026. The respondents indicated that they agreed with the statement since the mean is close to 4. However, the response has the highest standard deviation meaning the respondents had varying responses towards this question.

From these findings, it can be concluded that most investors in real estates are concerned with the effect of capital allowances on performance compared to its effect on overall transaction cost. This supports earlier findings in section 4.5 that profitability is major indicator of performance in real estate businesses.

### 4.7.3 Lock in Effect and Performance

The third objective sought to determine the influence of lock-in on performance of real estate business in Mavoko Municipality Machakos County. The responses based on 113 respondents were recorded in table 4.11 below

**Table 4.11:** Lock in Effect and Performance

| Statement | Mean | Std. Dev. |
|---|---|---|
| Lock in effect influence level of investment in real estate business | 3.53 | 1.155 |
| Lock in effect influence the supply of real property | 3.41 | .829 |
| Lock in effect has impact on transaction costs in REBs | 2.96 | .871 |
| Lock in effect affect purchases of real estate | 3.84 | 1.120 |

**Source:** Research data (2019)

From table 4.11 above, the statement lock in effect affect purchases of real estate had the highest mean of 3.84 and a high standard deviation of 1.120 while the statement lock in effect has impact on transaction costs in real estate business had lowest mean of 2.96 and a low standard deviation of 0.871. Most respondents agreed with the statement that lock in effect has impact on transaction costs in real estate businesses.

The findings indicate that most real estate businesses are concerned with the influence of lock in effect on purchases of real estate property and least concerned with how lock in effect affect transaction costs. This means that performance of real estate business depends on the purchases made per unit time and least depends on the transaction costs.

### 4.7.4 Capitalization Effect and Performance

The fourth objective was to determine the influence of capitalization effect on performance of real estate business in Mavoko Municipality Machakos County. The responses based on 113 respondents were recorded in table 4.12 below

**Table 4.12:** Capitalization effect and performance

| Statement | Mean | Std. Dev. |
|---|---|---|
| Capitalization effect has impact on demand for real estates | 3.62 | 1.032 |
| Capitalization effect influences value of real estate property | 2.77 | 1.002 |
| Capitalization effect has impact on transaction cost in REBs | 2.94 | .998 |
| Capitalization effect influences sales of real estates | 3.90 | 1.034 |

**Source:** Research data (2019)

From table 4.12, the statement capitalization effect influences sales of real estates had the highest mean of 3.90 and the highest standard deviation of 1.034 while the statement capitalization effect influences value of real estate property had lowest mean of 3.92 and the largest standard deviation of 1.002.

These findings show that investors in real estates are concerned with how capitalization effect influences sales of real estates and least concerned with influence of capitalization effect on value of real estate property. As such, a conclusion that performance of real estate business depends on sales made per unit time was made.

### 4.8 Correlation Analysis

Correlation analysis was performed to examine the association between independent and dependent variables. The correlation coefficients range from -1 for perfect negative relationship to +1 for perfect positive relationship through zero for no relationship. Table 4.6 below shows the correlation coefficients between the variables

**Table 4.13:** 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 Gains** | 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 -Effect** | Pearson Correlation | -.401** | .648** | .547** | .702** | 1 |
| | Sig. (2-tailed) | .006 | .000 | .000 | .000 | |
| | N | 113 | 113 | 113 | 113 | 113 |

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

**Source:** Research data (2019)

The results on the table above show a strong positive correlation between business performance and capital gain of 0.542 and a p-value of .000. This means that the correlation is significant at 0.05 significant levels. An increase in capital gain will lead to increase in performance of real estate business meaning the two moves

together in same direction. Capital allowance and performance had a weak positive correlation of 0.393 with a p-value of 0.004 which is less than significant level of 0.05. However, a negative correlation of 0.521 accompanied by p-value of 0.000 exists between lock-in effect and performance. Capitalization effect with performance had a negative correlation coefficient of 0.401 with a p-value of 0.006. A negative correction shows that as lock in effect occurs, performance will reduce.

## 4.9 Regression Analysis

After establishing that there was correlation between dependent and each of independent variable, it was necessary to test the combined effect of the independent variables to profitability. Model Summary, analysis of variance (ANOVA) and regression coefficients were generated.

### 4.9.1 The Model Summary

The model summary consists of R. value, R square value, adjusted R squared value, and a standard error of the estimate. The values obtained were recorded in table 4.14 as shown below.

**Table 4.14:** Model Summary

| Model | R | $R^2$ | Adjusted $R^2$ | Std. Error | $R^2$ Change | F Change | $df_1$ | $df_2$ | Sig. F Change |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | Change Statistics | | | | |
| 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 above shows that the R value is 0.711, while the value of r-squared is 0.506. The 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.

**4.9.2 ANOVA**

Analysis of variance (ANOVA) was done to confirm the model's fitness explaining the variations in depended and independent variable. Specifically, the analysis of variance was done to generate the f- statistic which is used to test significance of R. The results were as shown in table 4.15 below

**Table 4.15:** 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

**Predictors:** Constant, capitalization effect, capital allowance, Lock-in effect and capital gain.

The value of the f-statistics (10.241) is statistically significant 0.05 alpha levels. The results indicate that the regression model is fit and that there is a significant association between each of the predictor variables and the business performance. The model was therefore fit in explaining the variations of dependent variable with independent variable.

**4.9.3 Regression Coefficients**

After establishing that there was correlation between dependent and each of independent variable, it was necessary to test the combined effect of the independent variables to performance. A regression analyses was done and results presented in table 4.16 below.

**Table 4.16:** Regression Coefficients

| Model | | Unstandardized Coefficients | | Standardized Coefficients | T | Sig. |
|---|---|---|---|---|---|---|
| | | B | Std. Error | Beta | | |
| 1 | (Constant) | .106 | .301 | | .353 | .726 |
| | Capital Gains | .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 |

a. **Dependent Variable:** Performance

From table 4.16 above, the constant term had 0.106 with a significant value of 0.726 while the capital gains 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 Y= $0.106 + 0.418X_1 + 0.231X_2 - 0.694X_3 - 0.300X_4 + \varepsilon$.

In absence of all other factors, performance of real estate businesses will be 0.106 as shown by the constant term. An increase in capital gains by one unit will lead to increase in performance of real estate businesses by 0.418 units while increase in capital allowances by a unit will increase performance by 0.231 units in absence of all other factors. The results also indicate that an increase in lock in effect by one unit will decrease performance by 0.694 units while for capitalization effect the performance will decrease by 0.300 units in absence of all other factors.

**CHAPTER FIVE**

## 5.0 DISCUSSIONS OF THE FINDINGS

### 5.1 Introduction

This chapter covers discussions of the results from a research whose objective was to establish the relationship between capital gains tax and performance of real estate businesses in Mavoko Municipality, Machakos County. Specifically, the chapter will discuss each of the objective and its connection with the results.

### 5.2 Discussion

The discussion of the findings are based on each of the independent variable. The researcher discussed the finding on how each of the independent variable relate to or affect the performance of real estate business.

### 5.2.1 Capital Gains and Performance

The first objective of the research was to determine the effect of capital gains on performance of real estate businesses in Mavoko Municipality, Machakos County where capital gains was one of the independent variable. The findings indicated that there is statistically significant relationship between capital gains and business performance. As such, a unit increases in capital gains result in an increase in business performance. This is expected especially where financial indicators are used in measuring performance. When an asset gains value, the sale price always supersedes the purchase price leading to surplus or profit after selling such an asset. The findings of this research agrees with earlier findings by Omboi (2011) who conducted a study on the factors influencing real estate property prices in Meru Municipality where his findings led him to conclude that the performance of real estates in Meru depends on the income derived from the said real estate. They also agree with study by Hou (2010) and a report by Knight Frank's (2011) Prime International Residential Index (PIRI), who both concluded that the bubbling effect is the reason behind emergence and growth of real estate businesses due to the increased prices of real estate asset.

### 5.2.2 Capital Allowances and Performance

The second objective was to establish the effect of capital allowances on performance of real estate business in Mavoko Municipality, Machakos County. The findings show

a statistically insignificant relationship between business performance and capital allowances. An increase in capital allowances by one unit will cause an increase in business performance. This is an expected scenario since capital allowances will have an overall effect of reducing the tax liability of a corporate. However, the study established that the relationship is insignificant meaning that though these capital allowances can lead to increased performance; they are not very important factors to consider in trying to increase performance of a real estate business. This could be attributed to the factor that the process of claiming those allowances is lengthy, cumbersome and resource consuming. These findings are consisted with findings by Njeru and Ndimitu (2015) who earlier assessed the effect of tax incentives on performance among Export Processing Firms where their findings revealed that investments in EPZ firms increased with increase in sales, profit as well as tax incentives. The influence of tax incentives on investments in EPZ was however found to be insignificant. However, the findings by Devereux, Maffini and Xing (2015) which focused on corporate tax incentives as well as firm performance indicated that corporate tax incentives affected the external leverage of both domestic and multinational companies meaning a significant relationship between corporate tax incentive and performance.

### 5.2.3 Lock in Effect and Performance

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 results showed a negative association between lock in effect with business performance.  An increase in in lock in effect one unit will to decrease in performance. This is also an expected scenario especially if performance of the businesses is measured in terms of profitability because when the sellers avoid selling their estate property for the fear of incurring transaction costs, they forego much more required revenue which makes the profitability of the ventures to low. These findings support earlier findings by Chyz and Oliver (2012) who examined the Lock in effect of capital gains tax 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 capital gain tax. However, with reduction of capital gain tax, the investors were willing to sell their current securities and acquire more securities in their portfolio. Where capital gain tax was high, they reported that the firms reported reduced profits but increased profits when the capital gains tax is low.

### 5.2.4 Capitalization Effect and Performance

The last objective was to determine the relationship between capitalization effect and performance of real estate business in Mavoko Municipality, Machakos County. Current study established that an increase in capitalization effect will result in a decrease in business performance. Increase in capital gain tax increases the transaction costs associated with the purchase of real estate property. As transaction cost increases, buyers will bargain for lower prices for real estate property so as to compensate for the tax which they will be required to pay when they later resale the estate property. These low prices reduce the profits obtained by the sellers. Transaction costs also have the effect of discouraging the buyers to completely shy away from buying real estate property leading to decreased demand. This supports earlier study by Sialm (2009) who conducted a study to investigate on the capitalization effect of capital gain tax in the United States where a cross section study revealed that increase in capital gain taxes contributed to the capitalization effect which led to less demand for real estates and low performance of a business venture. Also, Coleman (2008) aimed at understanding how CGT charged on real estate would affect the economy. He found that 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. This decreased capitalization effect makes the real estate sector to grow.

# CHAPTER SIX

## 6.0 CONCLUSIONS AND RECOMMENDATIONS

### 6.1 Introduction

This chapter provides a conclusion and recommendations of the key findings of the study. The conclusions reached were based on the information gathered and aimed at ensuring that real estate sector do not get hurt by the newly introduced Capital Gains Tax.

### 6.2 Conclusion

The current study sought to determine the effect of capital gains tax on performance of real estate businesses in Mavoko Municipality, Machakos County. The dependent variable was performance whose indicators were profitability, operational efficiency, growth and level of investments in real estates. The independent variable was capital gain tax whose components were capital gain, capital allowances, lock-in effect and capitalization effect. The conclusions are based on the objectives of the research and a general conclusion is also given.

### 6.2.1 Capital gains and Performance

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 show 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 exists a direct relationship between performance and capital gains 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 gains of their estate firms since it's a major determinant of performance in real estate sector.

### 6.2.2 Capital Allowances and Performance

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.

### 6.2.3 Lock in Effect and Performance

The third objective was to find out the relationship between lock in effect and performance of real estate businesses in Mavoko Municipality, Machakos County. The findings showed a negative and significant association between lock in effect and business performance. A conclusion was made that there is an inverse relationship between lock in effect and business performance in real estate business in Mavoko Municipality. Lock in effect reduces supply of a property in a property market as the investor shy away from selling their property due to increased transaction costs associated with capital gain tax. As such, the managers of real estates should balance between holding their assets to avoid transaction costs leading to low performance and selling their real estate property and incur transaction cost which could also lower their performance. They should strike a balance and come up with a decision that will maximize profits while at the same time minimizing the risks.

### 6.2.4 Capitalization Effect and Performance

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.

A general conclusion was made that, capital gains tax significantly affects the performance of real estate business in Mavoko Municipality, Machakos County. Capital gains tax brings in the concept of increased transaction cost. These transaction costs may include the costs of tax compliance, claiming of tax incentives and increased tax liability. Transaction costs have the effect of increasing business expenses leading to reduction in overall profit. Increased transaction costs bring in the lock in effect and capitalization effect. As transaction cost increases, the sellers of real estate property try to avoid the costs by reducing the number of units sold. This brings in shortage of real estate property leading to lock in effect. On the other hand, the buyers of real estate property avoid taking the burden of the transaction cost by either avoiding purchase of estate property or even by bargaining for a low price since they will still incur other transaction cost. Collectively, these lead to capitalization effect which significantly affects performance of real estate business.

## 6.3 Recommendations

This section gives the recommendations based on the findings and conclusions made in the current study. The recommendations are made to key stakeholders in real estates as well as to the researchers who are of great help to the growth of real estate business through research.

### 6.3.1 Recommendation to Policy Makers

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.

### 6.3.2 Recommendations to Practitioners

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.

### 6.3.3 Recommendations for Further Studies

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.

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**APPENDICES**

**APPENDIX I: LETTER FOR DATA COLLECTION**

**SOUTH EASTERN KENYA UNIVERSITY**
OFFICE OF THE DIRECTOR
**BOARD OF POST GRADUATE STUDIES**

P.O. BOX 170-90200
KITUI, KENYA
Email: info@seku.ac.ke

TEL: 020-4213859 (KITUI)

Email: directorbps@seku.ac.ke

Our Ref: D61/MAC/20563/2014

DATE: 4th March, 2019

Muli Jeremiah Musyoka
Reg. No. D61/MAC/20563/2014
Masters of Business Administration
C/O Dean, School of Business and Economics

Dear Musyoka
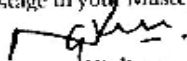
**RE: PERMISSION TO PROCEED FOR DATA COLLECTION**

This is to acknowledge receipt of your Master in Business Administration Proposal document entitled: *"The Relationship between Capital Gains Tax and Performance of Real Estate Business in Mavoko Municipality, Machakos County"*.

Following a successful presentation of your Masters Proposal, the School of Business and Economics Board of Examination in conjunction with the Directorate, Board of Postgraduate Studies (BPS) have approved that you proceed on and carry out research data collection in accordance with your approved proposal.

During the research work, you will be closely supervised by Dr. Robert Ombati. You should ensure that you liase with the supervisor at all times. In addition, you are required to fill in a Progress Report *(SEKU/ARSA/BPS/F-02)* which can be downloaded from the University Website.

The Board of Postgraduate Studies wishes you well and a successful research data collection exercise as a critical stage in your Master of Business Administration.

Prof. Felix Ngunzo Kioli
Director, Board of Postgraduate Studies

Copy to:   Deputy Vice Chancellor, Academic, Research and Students Affairs (Note on File)
Dean, School of Business and Economics
Director, Machakos Campus
Chairman, Department of Business and Entrepreneurship
Dr. Robert Ombati
BPS Office           To file

## APPENDIX II: INTRODUCTORY LETTER

Jeremiah M. Muli,

P.O box 50-90103

Wamunyu-Machakos

Dear respondent,

**RE: REQUEST TO COMPLETE THE ATTACHED QUESTIONNAIRE**

I am a student at **SOUTH EASTERN KENYA UNIVERSITY** pursuing a Master Degree in Business Administration (Finance Option). My Research Project is on the **EFFECT OF CAPITAL GAINS TAX ON PERFORMANCE OF REAL ESTATE BUSINESSES IN MAVOKO MUNICIPALITY, MACHAKOS COUNTY.** Please fill in the questionnaire below which is aimed at collecting information on the above given topic. The information provided will be held confidential and used for the purpose of enabling the researcher to accomplish an academic requirement.

Yours faithfully

Jeremiah Muli

**Cell phone: 0720916354**

**Please respond to each question by putting a tick (√)**

**PART A: <u>BACKGROUND INFORMATION</u>**

1. **What is your position in the organization (please tick only one option)**

   Director                          ( )

   Manager                          ( )

   Accountant                       ( )

   Sales person                      ( )

   Receptionist                      ( )

2. **What is nature of your business?**

   Buying and renting                ( )

   Building and Selling              ( )

   Buying and selling                ( )

   Other (specify)………………….

   **PART B: Performance of real estate business** (REBs)

   This section aims at establishing the effect of capital gain tax on the performance of REBs

3. **What is major indicator of performance in your business?**

   (a) Profitability    of business                                       ( )

   (b) Operational efficiency of business                          ( )

   (c) Growth of    real estate business                            ( )

   (d) Level of investment in real estate business             ( )

   (e) Other.

      Explain……………………………………………………………………………

4. **Please indicate (√) your agreement or otherwise with the statement below using the following Likert scale**

| 5=strongly agree, 4=agree, 3=Neutral, 2= disagree, 1=strongly disagree | | | | | |
|---|---|---|---|---|---|
| Statement | 1 | 2 | 3 | 4 | 5 |
| Capital gain tax has impact on  profitability of REBs | | | | | |
| Capital gain tax affects the operational efficiency of REBs | | | | | |
| Introduction of CGT has affected the growth of REBs | | | | | |
| Capital gain tax influences investments in real estate business | | | | | |

**PART C: Capital gain and performance of real estate business**

This section aims at establishing the effect of Capital gain on the performance of REBs

5. **How does Capital gain affect the performance of your business?**

(a) increases the profitability                              ( )

(b) increases the operational efficiency                 ( )

(c) encourages growth of the business                   ( )

(d) Increased investment in real estate business       ( )

(e) Other. Specify……………………………………………………………………

6. **Please indicate (√) your agreement or otherwise with the following statements using the following Likert scale**

| 5=strongly agree, 4=agree, 3=Neutral, 2= disagree, 1=strongly disagree | | | | | |
|---|---|---|---|---|---|
| Statement | 1 | 2 | 3 | 4 | 5 |
| Increased capital gain increases return on assets in REBs | | | | | |
| Level of Capital gains determines size of real estate business | | | | | |
| Increased capital gains encourages investments in REBs | | | | | |
| Amount of  capital gain determines the willingness of an investor to sell their property | | | | | |

**PART C: Capital allowances and performance of real estate business**

This section aims at establishing the effect of capital allowances on the performance of Real Estate Business

**7. How do capital allowances affect the performance of your business?**

(a) Increased profitability   of business                         ( )

(b) Increased operational efficiency of business                  ( )

(c) Encourages growth of business                                 ( )

(d) Encourages investment in real estate business                 ( )

(e) Other. Explain………………………………………………………………………..

**8. Please indicate (√) your agreement or otherwise with the following statements using the following Likert scale**

| 5=strongly agree, 4=agree, 3=Neutral, 2= disagree, 1=strongly disagree | | | | | |
|---|---|---|---|---|---|
| Statement | 1 | 2 | 3 | 4 | 5 |
| Form of capital allowance has impact on performance of REBs | | | | | |
| Information on CA influence amount of CA claimed by REB | | | | | |
| capital allowance has impact on transaction costs in REBs | | | | | |
| capital allowance has effect on tax liability of REBs | | | | | |

**PART D: Lock in Effect and performance of real estate business**

This section aims at establishing the effect of lock in effect on the performance of REBs

**9. How does Lock in Effect affect the performance of your business?**

(a) Reduced profitability   of business                           ( )

(b) decreased operational efficiency of business                  ( )

(c) Reduced growth of    business                                 ( )

(d) Discourages investment in real estate business                ( )

(e) Other.

   Explain………………………………………………………………………………

**10. Please indicate (√) your agreement or otherwise with the following statements using the following Likert scale**

| 5=strongly agree, 4=agree, 3=Neutral, 2= disagree, 1=strongly disagree | | | | | |
|---|---|---|---|---|---|
| Statement | 1 | 2 | 3 | 4 | 5 |
| Lock in effect influences level of investment in  real estate business | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| Lock in effect influence the supply of real estate property | | | | | |
| Lock in effect has impact on transaction costs in real estate business | | | | | |
| Lock in effect has impact purchases of real estates | | | | | |

**PART E: Capitalization effect and performance of real estate business**

This section aims at establishing the effect of "capitalization effect" on the performance of REBs

**11. How does capitalization effect affect the performance of your business?**

(a) Reduced profitability    of business           ( )

(b) decreased operational efficiency of business        ( )

(c) Reduced growth of    business             ( )

(d) Discourages investment in real estate business     ( )

(e) Other.

      Explain……………………………………………………………………………

**12. Please indicate (√) your agreement or otherwise with the statement below using the following Likert scale**

| 5=strongly agree, 4=agree, 3=Neutral, 2= disagree, 1=strongly disagree | | | | | |
|---|---|---|---|---|---|
| **Statement** | 1 | 2 | 3 | 4 | 5 |
| capitalization effect has impact on demand for real estates | | | | | |
| capitalization effect influences value of real estate property | | | | | |
| capitalization effect has impact on transaction cost in REBs | | | | | |
| capitalization effect influences sales of real estates | | | | | |

**Thank you for your responses**

# APPENDIX IV: REAL ESTATE BUSINESSES IN MAVOKO MUNICIPALITY

| S.No | Name |
|------|------|
| 1 | Arkbridge Properties Limited |
| 2 | Cambrian Valuers Limited |
| 3 | Datoo Kithikii Ltd |
| 4 | Denko Properties Ltd |
| 5 | Dinesh Construction Ltd |
| 6 | Dunhill Consulting Limited |
| 7 | Eastwood Consulting Limited |
| 8 | Epco Builders Ltd |
| 9 | Erated Properties Limited |
| 10 | Fort Properties Ltd |
| 11 | Gladden Delight Investments Limited |
| 12 | Ken Banco House Ltd |
| 13 | New Age Construction Ltd |
| 14 | Ongata Works Ltd |
| 15 | Onward Properties Limited |
| 16 | Opus Properties Ltd |
| 17 | Penwill Properties Ltd |
| 18 | Piton Top Management Co. Ltd. |
| 19 | Plenser Limited |
| 20 | Prestige Management Valuers Ltd |
| 21 | Property Hub Kenya Ltd |
| 22 | Property Hub Limited |
| 23 | Sabea Investments Limited |
| 24 | Seventy-Seven Properties Limited |
| 25 | Shash Marketing Ltd. |
| 26 | Sitesteps Mpa Ltd |
| 27 | Teita Estate Ltd |
| 28 | Ujenzi Land Investment Forum (K) Ltd |
| 29 | Value Peak Limited |
| 30 | Vitara Properties Ltd |
| 31 | Westcon Contractors Ltd |

# APPENDIX V: TIMEFRAME

The researcher will take 6 months to finish the study running from September 2018 to June 2019

| Month /Activity | SEP 2018 | OCT 2018 | NOV 2018 | JAN 2019 | FE B 2019 | MAR 2019 | APR 2019 | MAY 2019 | JUNE 2019 |
|---|---|---|---|---|---|---|---|---|---|
| Writing Proposal | ▓ | ▓ | | | | | | | |
| Submitting and Defending Proposal | | | ▓ | | | | | | |
| Data Collection and Analysis | | | | ▓ | ▓ | ▓ | ▓ | | |
| Report Writing | | | | | | ▓ | ▓ | | |
| Final Defense | | | | | | | | ▓ | ▓ |
| Corrections | | | | | | | | ▓ | ▓ |
| Publishing | | | | | | | | ▓ | ▓ |

**Source: Author 2019**

## APPENDIX VI: BUDGET

| Activity | Cost (KSH) |
|---|---|
| Travelling expenses | 7500 |
| Typesetting, printing and binding of project | 15000 |
| Printing of questionnaires | 5000 |
| Research assistant | 10000 |
| Airtime | 2000 |
| Subsistence | 7000 |
| **Total** | **46500** |

**Source: Author 2019**