Do Capital Gains Taxes Matter?

BY KEVIN FLYNN, CPA, AND A.J. CATALDO, CMA, CPA

When an investor who falls within the jurisdiction of the U.S. income tax system sells a capital asset (i.e., stock) at a gain, that investor is subject to pay a capital gains tax. Theoretically, paying a capital gains tax is a negative consequence that could influence an investment decision. An investor could be less likely to purchase or sell a stock to avoid paying a capital gains tax.

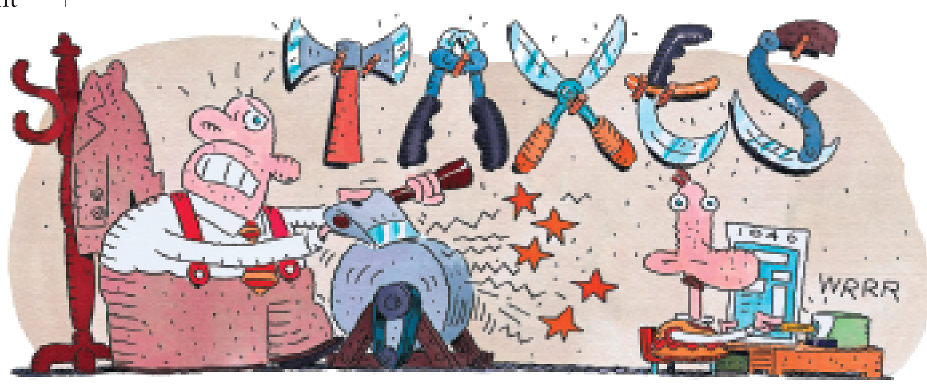
But does the imposition of a capital gains tax really influence an investor's decision?

Lock-in Effects

Academics refer to one of the negative conditions caused by the imposition of capital gains taxes as a "lock-in" effect. Put simply, some investors will feel "locked in" to a financial instrument or investment vehicle simply because the realization and recognition of the capital gain will result in the imposition of tax. The payment of the tax on the gain results in a reduction of the net worth otherwise enjoyed by the taxpayer/investor. It's for this reason that tax-free exchanges (e.g., IRC §1031) and all other forms of tax deferral are popular. This is the *microeconomic* perspective.

From the *macroeconomic* perspective, this "locking in" of economic resources may inhibit their free flow into alternatives that would maximize returns, meaning that these resources wouldn't be applied to their "highest and best use." For example, a new firm that might be seeking capital to build a plant for an alternative fuel source might enjoy some lesser measure of investment capital simply because it operates in a time period or country with high capital gains tax rates. In China, for instance, Chinese law imposes a 20% capital gains tax, but the government stopped collecting the tax in 1994 in an effort to facilitate the development and growth of its equity market. This not only helps it avoid the creation of an investment environment that limits what companies can do with their capital, but it also maximizes the free flow of economic resources.

It's difficult to isolate and quantify the impact of the imposition of a capital gains tax on taxpayer/investor behavior. For example, the Jobs and Growth Tax Relief Reconciliation Act



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of 2003 (the Act) reduced the capital gains tax rate from 20% to either 15% or 10%, depending on the taxpayer's marginal tax bracket. Academic literature suggests that this change would result in some increase in stock purchases, stock prices, and the "unlocking" of some economic resources because those unwilling to pay 20% may be willing to pay a 15% or 10% tax. The Act also lowered the tax rates on dividend income and ordinary income, however, and provided either new or expanded deductions or credits. As such, it could be argued that an upsurge in stock buying could have at least partially resulted from the reduced dividend tax rates, the reduced ordinary income tax rates, or simply because the increased deductions and credits caused taxpayers to have more money to invest.

A One-Day Decline

Recent events in China have given us the opportunity to isolate the impact that capital gains taxes have on investors because a specific stock market reaction appears to have been causally linked to a single event. China had the world's best performing equity market in 2006, as demonstrated by the more than 130% increase in the Shanghai Composite Index (SSE). On March 23, 2007, the same Shanghai composite index closed at an all-time high at 3,074.29, up 14% for the year.

On February 27, 2007, however, the SSE declined 8.8% in a single trading day. Aside from the recent meteoric rise that could cause anyone to be concerned, a published report by BBC News suggests that the "straw that broke the camel's back" on that date appeared to be a rumor that the Chinese government was going to enforce the 20% capital gains tax. Presumably, the overreaction to the rumors on February 27 was due to investors seeking to take the gains before being "locked-in" and subject to the imposition of the new capital gains tax.

The following day, February 28, according to Chinadaily.com.cn, the Chinese Ministry of Finance and the State Administration of Taxation announced that the Chinese government had no plans to enforce the capital gains tax. By the end of that day, stock prices had risen, and the SSE started to recover, increasing by 3.9%.

Though other concerns such as the fear of inflation may have contributed to the SSE decline-recovery sequence, the fear of capital gains tax imposition (February 27th decline) and the assurance that no capital gains tax would be imposed (February 28th recovery) represent two identifiable events resulting in observable, causally linked, significant market reactions. While the continuation of the imposition of capital gains taxation at some level remains politically necessary in the U.S. (as an *equity* or *fairness* or *ability to pay* issue), the one-day decline or reaction that affected the SSE on February 27, followed by the recovery that began on February 28, is intuitively appealing, consistent with, and appears to support the findings from academic research. Capital gains taxes *do* matter. ■

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