



# Capital gains tax and equity values: Empirical test of stock price reaction to the introduction and reduction of capital gains tax exemption ☆

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## Abstract

This paper evaluates the differential effect on stock prices of the introduction in Canada of \$500,000 capital gains tax exemption and the reduction of this limit to \$100,000 two years later. Using the seemingly unrelated regression methodology and controlling for thin-trading and heteroscedasticity, the empirical evidence indicates that the changes in capital gains tax laws had a differential effect on low-dividend yield and high-dividend yield stocks on both occasions. While the evidence indicates that the stock market anticipated the 1985 capital gains tax law changes, the significant market reaction to the 1987 reduction of the exemption occurred a day before and after the reading of the tax reform proposals in Parliament. Thus, it can be inferred from the results that, despite the presence of tax-sheltering opportunities in Canada, changes in capital gains tax laws affect equity values.

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...A small but expanding body of research has documented an effect of capital-gains taxes on asset prices, particularly the prices of common stock. Amoako-Adu, Rashid and Stebbins (1992) find that the introduction of the Canadian capital-gains tax was associated with substantial asset revaluations. Lang and Shackelford (2000) and Shackelford (2000b) present evidence for the United States, showing that the stocks that were best positioned to benefit from lower capital-gains tax rates rose the most when legislators moved toward capital-gains tax reduction in 1997...

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