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Will Stocks Fall if Capital Gains Tax Rates are Raised?

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Executive Summary

- Our analysis found that there is no historical correlation between the maximum capital gains tax rate and stock market returns
- Despite changes in tax rates, in most periods (including when taxes go up), the S&P 500 has generated strong returns
- However, tax rate increases have resulted in increased realization of capital gains, so some pickup in equity selling activity might be expected
- While rates have varied dramatically over the past 60+ years, Biden's proposed increase of 19.6% is unprecedented, so historical comparisons provide context but are imperfect

Why Should You Care?

Stocks fell sharply on April 22nd after a report surfaced that President Joe Biden is considering a hefty increase in capital gains taxes. Biden's proposal would raise the maximum capital gains rate up to 43.4% (including the 3.8% healthcare surcharge) from the current rate of 23.8%. This would mark a steep increase and would be the highest level since the 1920's when capital gains income was subject to a maximum rate of 77%.

The tax would only apply to those reporting more than $1M in income. According to recent IRS data, this would affect ~540,000 people, or 0.3% of taxpayers. However, the impact would likely still be quite large as IHS Markit estimates that the top 0.3% of taxpayers own between 20-25% of U.S. equities.

History of the Maximum Capital Gains Tax Rate

Since the 1950's, maximum tax rates have varied dramatically, with a high of nearly 40% in the mid-70s and a low of 15% following the 2008 financial crisis. The current rate of 23.8% sits just below the 25.2% historic average. The largest tax rate changes since the 1950's were a 10.1% increase from 2012-2013 and an 11.9% decline from 1978-1979. Biden's increase of 19.6% would be unprecedented, so historic analysis must be taken with a grain of salt. Additionally, many previous tax rate changes have applied to several tax brackets, while Biden's proposal would just apply to a new higher top tax bracket.

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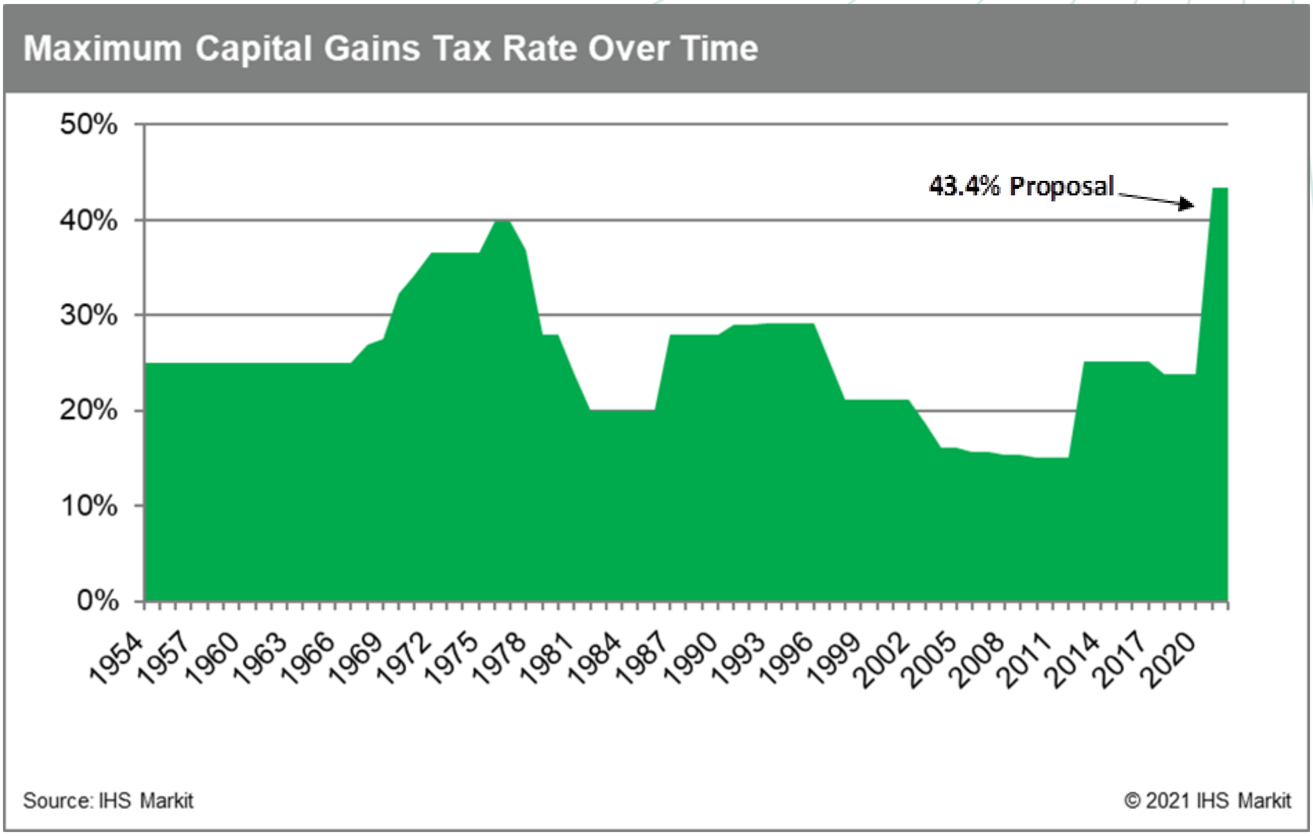


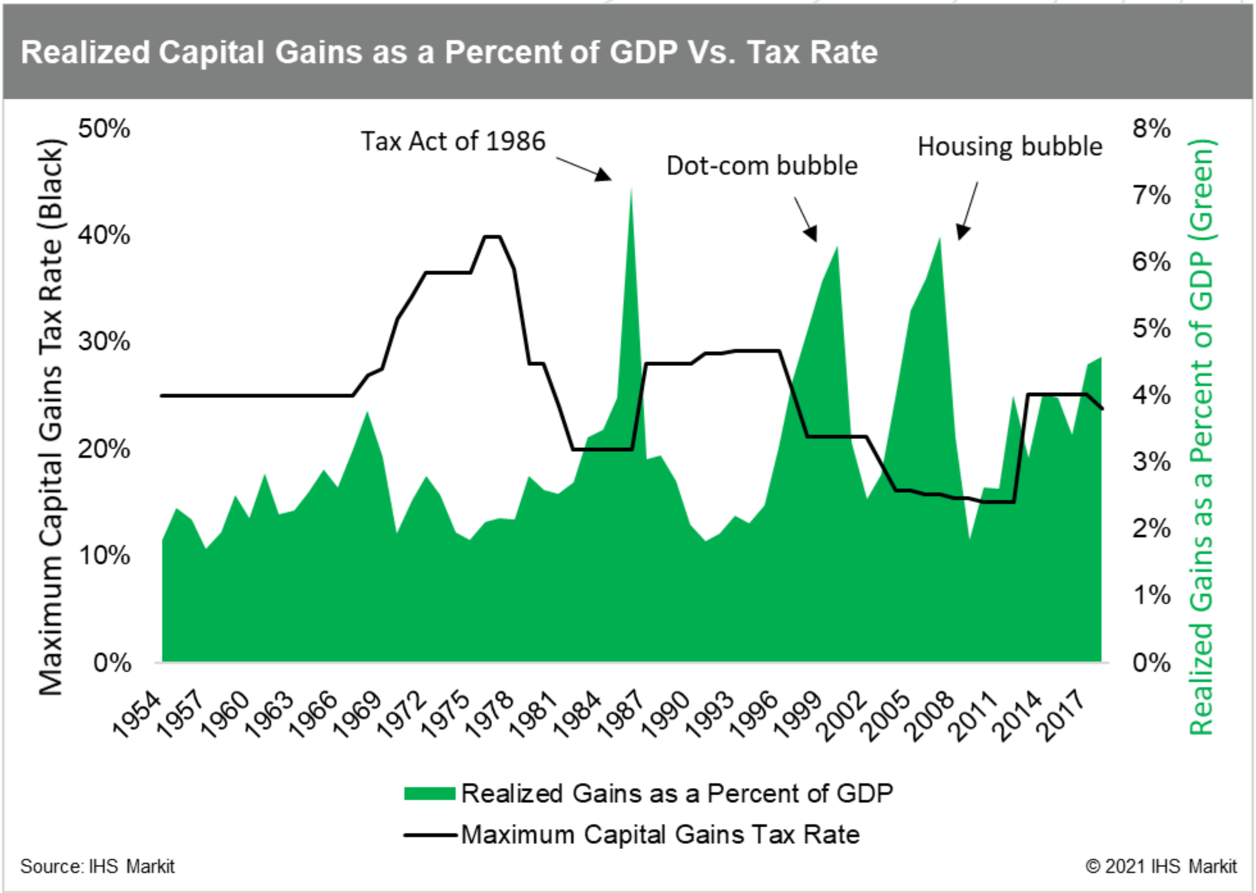
Realized Capital Gains

Since the 1950's, there have been three notable events where investors realized an unusual amount of capital gains.

The first event occurred in 1986 where investors realized an amount equivalent to over 7% of U.S. GDP, according to US Treasury data. This was a clear outlier as no other year in the 1980's had investors realized higher than 4% of GDP. There are two possible explanations. First, The Tax Reform Act of 1986 increased the average effective capital gains tax rate from 16.1% to 22.7% from 1986-1987 and this spurred investors to sell stocks before the higher rates came into effect. The second explanation is that the S&P 500 had averaged a 20% return per year from 1982-1986 and investors wanted to lock in the gains.

The second event occurred in the late 1990's when the stock market was on fire, having averaged a 29% return from 1995-1999. The realization of capital gains started picking up in 1996 but it should be noted that in mid-1997 the top capital gains tax rate fell by 8 percentage points, from 29.2% to 21.2%.

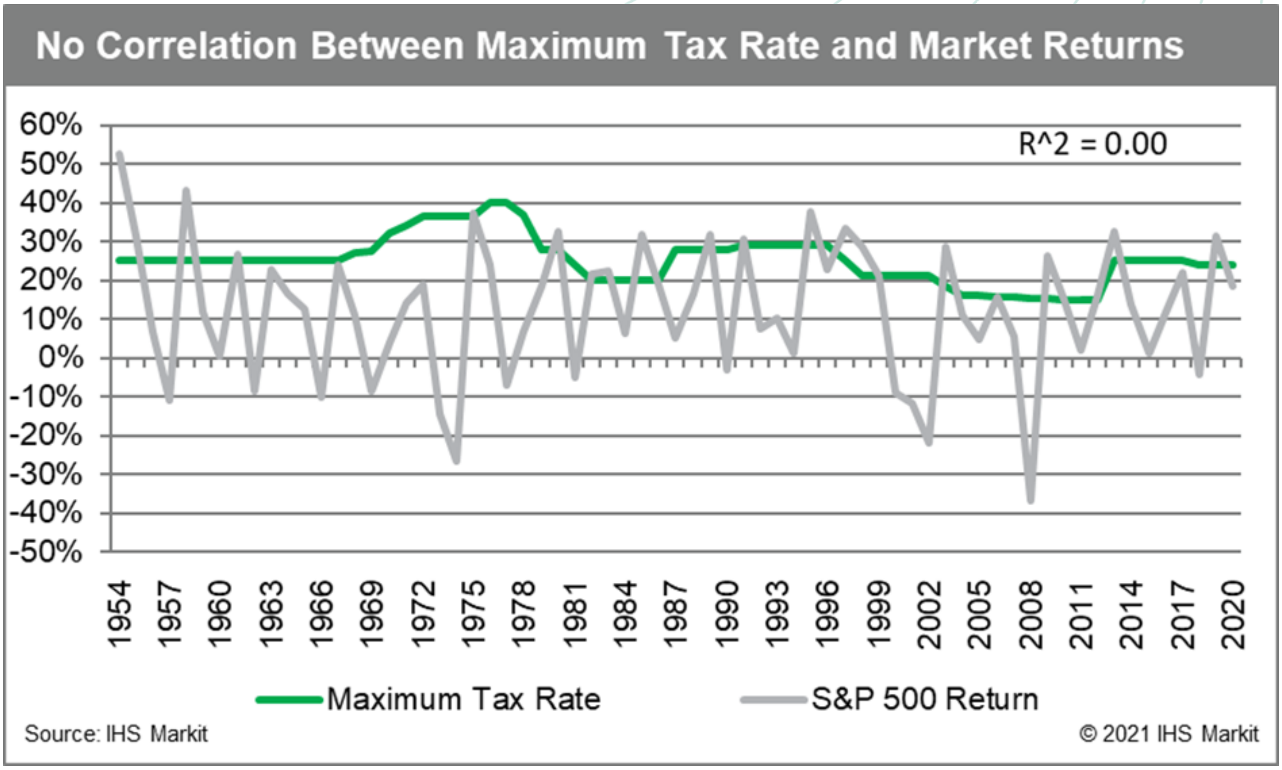
Finally, the third event in which we saw elevated realized capital gains occurred in the 2006-2007 housing bubble when tax rates remained relatively unchanged, and the market was steadily increasing.



No Correlation Between Maximum Capital Gains Rate and Market Returns

When looking at the market, there appears to be no correlation between the maximum capital gains tax rate and returns.

- From 1978-1979, the maximum capital gains rate fell from nearly 40% to 28% and the S&P 500 returned 7% in 1978 and 18% in 1979.
- From 1980-1981, the rate fell from 28% to 20% and the S&P 500 returned 32% in 1980 and -5% in 1981.
- From 1986-1987, the rate rose from 20% to 28% and the S&P 500 returned 19% in 1986 and 5% in 1987.
- From 2012-2013, the rate rose from 15% to 25% and the S&P 500 returned 16% in 2012 and 32% in 2013.



Conclusion

As highlighted in activity surrounding The Tax Reform Act of 1986, there is moderate evidence that an upward change in tax rates increase the amount of equities sold. However, the impact has historically been stifled by other factors such as bull markets. Therefore, we have no historic evidence to conclude that Biden's tax increase would cause the market to fall, though we would likely see an increase in realized capital gains. A major caveat is that the proposed increase by Biden is unprecedented and thus historical data may not be representative of future outcomes.