Call us:
866-CREATIVE

Email us:
cpi@creativeplanning.com

Visit us online:
www.creativeplanning.com

JULY 2021

WILL TAX CHANGES SINK THE MARKET?

Andrew H. Fuller, MSF, CFP®
Partner, Managing Director

Staying Calm in the Maelstrom

As if new COVID variants, global supply chain issues, rising (transitory?) inflation and the LA Clippers' playoff performance[1] is not enough to worry about, we recently got a peek at a proposed set of tax law changes that could have many investors fearing the worst. Will newly proposed corporate tax rates kill the market rally? If that doesn't do it, will proposed increases to capital gains rates for individuals finish the job?

President Biden's campaign argued for higher corporate tax rates and an increase to personal tax rates on high-income Americans. The administration is now translating these ideas into a slate of proposed laws. While the purpose of this article is not to explain in detail the exact nature of these policies,[2] suffice it to say that the increases are substantial, at least in terms of the rates themselves. If passed, capital gains tax rates would almost double for high-income earners, and corporations would see a 33% rate increase (from 21% to 28%).[3]

While dealmaking and negotiations in Congress may substantially change these policies before they're enacted, for the sake of argument, let's assume they all went into effect later this year. How would that impact the stock market?

Over the years you've heard us argue that the market only cares about one thing: earnings. If companies in the aggregate make more money, we can logically expect that the market will go up. If companies make less money, then we expect the value of those companies would go down. Thus, it is not difficult to see how, if companies are required to send more of their earnings to the government, investors might be concerned about a potential drop in the stock market. Thankfully,[4] since this would not be the first time the markets experience a tax rate increase, we have some historical data to guide our thinking. Let's explore.

Corporate Rate Impact

If Biden's corporate tax rate goes into effect, it would be the first time since 1993 that rates increased, and the sixth since 1945.[5] Far from a meltdown, though, the calendar

---

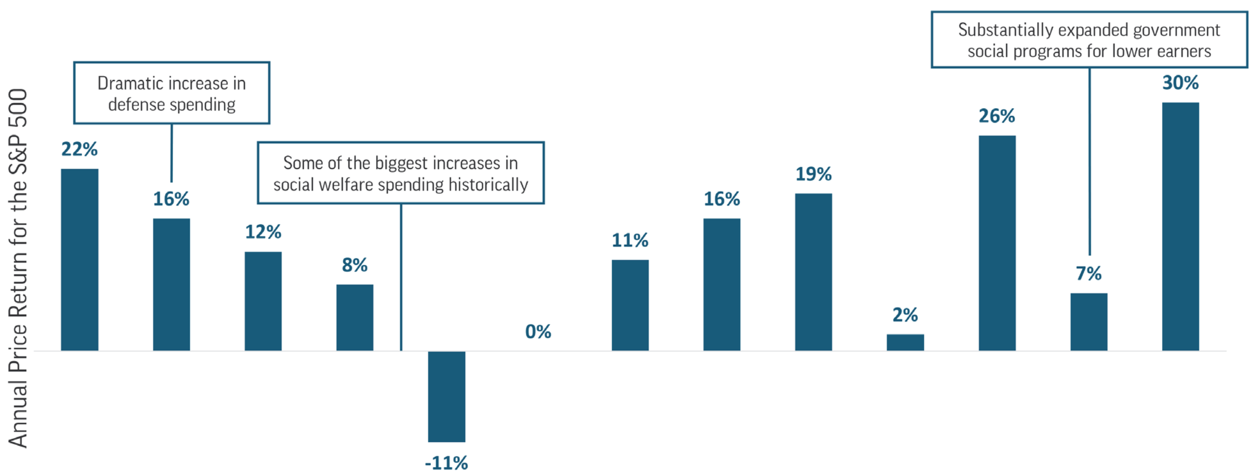
1 *As a long-time Utah Jazz fan, I am required to be upset about this.*
2 *Our in-house tax team and your wealth manager will keep you apprised of any changes that are relevant to you.*
3 *U.S. Department of the Treasury, "The Made in America Tax Plan" and "The General Explanations of the Administration's FY2022 Revenue Proposals."*
4 *Perhaps "unfortunately" would be a better a word choice here.*
5 *"U.S Federal Corporate Tax Rate 1909-2021," Internal Revenue Service and Trading Economics. Corporate tax rate increases occurred in 1950, 1951, 1952, 1968 and 1993.*

year performance for the S&P 500 index each of those times had an average return of +12.9%, with each year having a positive return and the *worst* year showing a gain of +7.06%.[6] In contrast, in years when tax rates actually *dropped*, the market did far worse, posting average returns of just +4.6% across the nine periods with lowered rates.[7] Do markets just not care about earnings? How is this possible?

One very important aspect to consider is the context in which these tax hikes and tax drops occurred. For example, average GDP growth during periods when tax rates increased was +5.9%,[8] or about triple the pre-COVID rate of growth.[9] Since a faster-growing economy implies higher earnings, the reduction from increased taxation wasn't enough to push the market negative. Rather, it was a tax on growth, and actual growth would likely have been higher had the rates not changed.

The U.S. Bureau of Economic Analysis indicated in their third revised estimate for Q1 2021[10] on June 24th that the U.S. economy is growing at an annualized rate of +6.4%. Assuming this rate (or something close to it) holds through the year, then the impact from higher taxes would likely be covered up by the overall growth in earnings, as it has been in prior years when tax rates moved higher.

Market Performance and Tax Changes Since 1950



Tax rate increase in:	1950	1951	1952	1968	1969	1970	1971	1972	1976	1987	1991	1993	2013
Personal	✓	✓	✓	✓							✓	✓	✓
Corporate	✓	✓	✓	✓								✓	
Capital Gains				✓	✓	✓	✓	✓	✓	✓	✓	✓	✓

Source: Haver Analytics/MPR

6 *Returns for the S&P 500 index were +21.78%, +16.46%, +11.78%, +7.66%, +7.06%, respectively. Source: Haver Analytics/FMR.*
7 *"Market Performance and Tax Changes since 1950," Haver Analytics/FMR.*
8 *U.S. Bureau of Economic Analysis*
9 *U.S. GDP growth in 2019 was 2.16%.*
10 *That's not a mistake, these numbers always go through multiple revisions before finalized.*

5454 W. 110th Street, Overland Park, KS 66211
direct: 866-CREATIVE | fax: 888-243-9402

Personal Rate Impact

If you've followed me this far, then it's time to get some coffee as this stuff only gets more exciting from here on out. Let's now look at how the changes to personal income tax rates may affect things.

Investor anxiety is growing.[11] Concerns are centered on whether investors with large gains will seek to sell their stocks in advance of a hike and thereby cause a market meltdown.

The simple answer is no, I believe this alone is not sufficient.

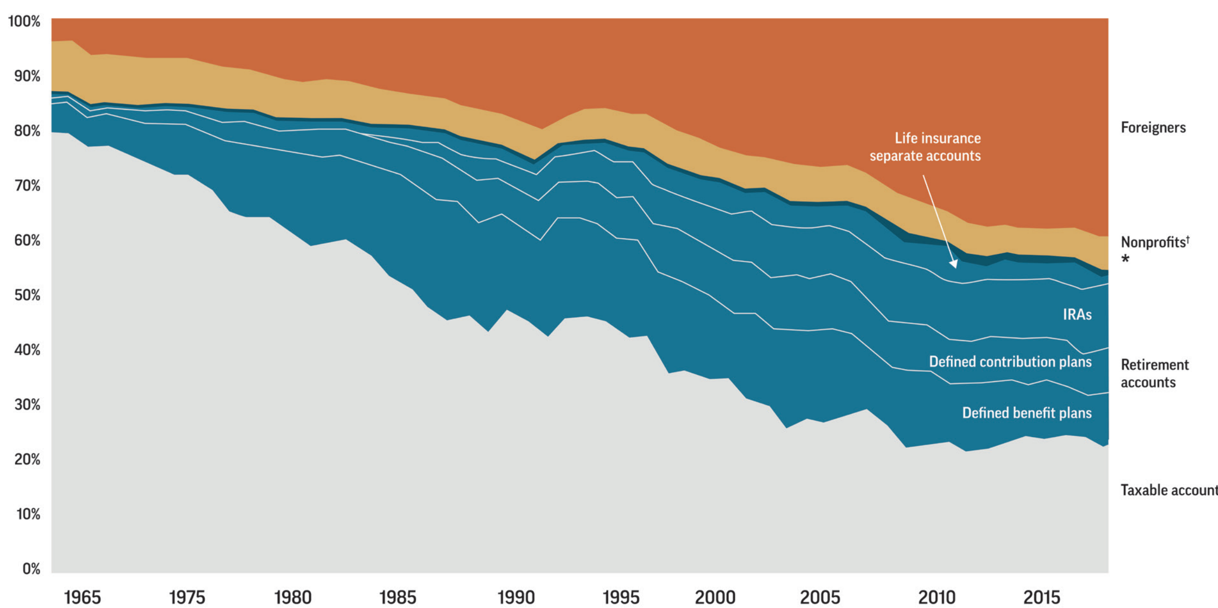
Many investors are considering selling to lock in the current rates, but these sales are likely to have a very limited effect on the market. More on this later. Further, Biden's proposed changes currently state the change would be retroactive to earlier this year,[12] blunting the benefit of early sales.

However, even if we assume the bill(s) will end up *not* being retroactive, we can be reasonably confident this selling would have little to no observable impact on the market. The historical record supports this conclusion quite convincingly.

Looking at the ten times since 1968 that personal capital gains rates were increased, we find only one year (1969) when performance of the S&P 500 was negative.[13] Further, the market today is built on a dramatically different foundation than it was back in 1969.

Percent Ownership of U.S. Corporate Stock, 1965-2019

(Direct and Indirect Holdings)



Source: Board of Governors of the Federal Reserve System, "Financial Accounts of the United States." Calculations by the Tax Policy Center. †Dashed lines indicate TPC estimates. *Federal, state and local government holdings, including equity in 529 college savings plans.

---

[11] *As measured by the size of my email inbox.*
[12] *The specific date is somewhat unclear.*
[13] *The S&P 500 posted a -11% return for calendar year 1969 and 0% return for 1970. Source: Robert Shiller and Yale University, "U.S. Stock Markets 1871-Present."*

5454 W. 110th Street, Overland Park, KS 66211
direct: 866-CREATIVE | fax: 888-243-9402

As illustrated by the chart on the previous page, over the past 50 years, the share of the total stock market subject to potential U.S. capital gains taxation—that is, the portion owned by individuals in taxable investment accounts—has dropped from approximately 80% in the late 1960s to just 25% today.

Foreign investors who are largely taxed at their home country's rates make up roughly 40%, with the balance being mostly retirement accounts such as 401(k), IRA and pension accounts. As you likely know, trading inside these retirement accounts is tax-exempt and changes in capital gains rates will not prompt any action here.

Combined, 75% of the U.S. stock market is sheltered from U.S. capital gains rates. As a result, factors other than the rate of taxation are likely to dominate near-term performance.

The Bottom Line: Expect Minimal Market Impact from Tax Changes

While these changes are not expected to cause a market meltdown, they will have some effect. However, the impact will not be as severe as some prognosticators would have you believe since tax rates were already expected to increase. Astute investors know that in 2025 comes the expiration of the Tax Cuts and Jobs Act. Valuations likely already reflect this fact and assume reductions to earnings after 2025, along with increases in ordinary income and capital gains taxes for individuals. As a result, any negative market movement from these new taxes is likely to be negligible.

The strong recovery we are seeing in global economic growth, the risk of lingering inflation and, of course, the ever-present potential of an unforeseen crisis would all likely have a more direct and significant impact on stock market performance in the near term.

Lastly, your wealth manager is aware of your specific needs and tax circumstances and our trading team individually manages your portfolio. This means we can account for the impact of current and future taxation every time we consider a trade. As a client of Creative Planning, you are well-positioned to weather this and any other economic or taxation storm that may be brewing.

5454 W. 110th Street, Overland Park, KS 66211
direct: 866-CREATIVE | fax: 888-243-9402