Wall Street braces for higher tax rates

If lawmakers let capital gains and dividend rates move higher, selling pressure could pick up and buyers could get stingy. But the effect could be quite small.

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NEW YORK (CNNMoney.com) -- The leading Democratic candidates for president have said they'd favor higher investment taxes on upper-income taxpayers - and Wall Streeters don't like it.

"With the very real prospect of an increase in the capital gains tax, anyone who is long stock will probably give serious consideration to taking profits sometime before the end of 2008," said Ted Weisberg, founder of brokerage house Seaport Securities, in an e-mail to CNNMoney.com.

"All things being equal, this clearly is NOT a positive," said Weisberg.

There are two forces at play.

For investors, higher taxes mean less potential return on a stock or mutual fund bought outside a tax-sheltered account, such as a 401(k) or IRA. So, the theory goes, they're not willing to pay as much as they otherwise would.

Second, investors would have an incentive to get out before higher rates take effect, creating selling pressure.

If lawmakers allow the 2003 tax cuts to expire, which they're scheduled to do by 2011, dividends would go back to being taxed at ordinary income tax rates. Currently, they are taxed at just a 15 percent rate.

The 15 percent long-term capital gains rate would revert to 20 percent.

Senators Hillary Clinton (D-NY) and Barack Obama (D-Ill.) have said they would support letting the cuts expire for those with taxable incomes over $250,000. Senator John Edwards said he'd like to do so for those whose incomes exceed $200,000.

The push to generate more tax revenue comes at a time when the federal budget will face stiff challenges from at least three factors: the likely reform of the Alternative Minimum Tax; the rising costs of Medicare and Social Security; and a growing bill coming due on U.S. debt issued to foreign investors.

There are studies showing that over the long-term there is a strong relationship between stock prices and tax rates. University of Texas economics professor Clemens Sialm looked at the effects of tax changes on stock prices from 1917 to 2004. He found that stock prices tend to be lower when taxes are relatively high.

Should there be a tax rate increase in the offing, it is likely that there will be some selling in the run-up to the anticipated change. "It could be a negative on the market in the quarter before an increase," said Charles Biderman, CEO of fund flow tracker TrimTabs.

Some mutual fund managers might take the opportunity to trim or reallocate in advance of a rate increase.

"If tax rates are likely to go up, it may also make financial sense to pay the tax early at the lower rate. We do believe that the current maximum rate of 15% (less in the lower tax brackets) is as low as it will be anytime soon," mutual fund manager Ron Muhlenkamp wrote in a recent letter to shareholders in the Muhlenkamp Fund (MUHLX (Charts).

Certified financial planner Steven Kaye said he is advising clients to consider taking some gains if they had been planning to get rid of an investment in the next two years.

Impact may be muted

Many market experts, however, caution against betting on a sharp selloff tied to the possibility of the tax-rate change.

For one thing, the selling pressure might not be as sharp as feared.

For example, Muhlenkamp also noted in his letter that the biggest reason to take gains is still if a stock price is likely to fall or there is a better use for the investment money.

And Kaye said that long-term investors don't necessarily have an incentive to sell: Over a period of seven to 10 years, you might come out ahead holding a stock, even if you'll ultimately pay a higher capital gains rate.

There are other factors too that could limit the impact. On average the tax law changes every five years or so. If the tax increase isn't considered "permanent," its impact could be lessened.

Also, far more investments today are held in tax-deferred accounts than was the case during major tax changes during the past 50 years.

Other events such as a war could dominate market movements. And companies might support their share prices by buying back stock or offering a large one-time dividend payout in advance of a change. And Princeton economist Harvey Rosen said firms may rely more on debt than equity to finance their growth.

The findings of one recent study by economists Gene Amromin of the Federal Reserve Bank of Chicago, Paul Harrison of Barclays Investors and Steven Sharpe of the Federal Reserve Board, found that the 2003 dividend tax cut didn't change aggregate stock valuations.

That's not to say the 2003 dividend tax cut didn't affect behavior. More companies started offering dividends and more investors reallocated into dividend-paying stocks and away from non-dividend paying ones.

"We do find that high-dividend-yield stocks (high tax burden ones) benefited from the cut, especially relative to low-dividend ones. In the aggregate, however, these two sets of equities seemed to offset each other, leaving little overall impact," wrote Amromin in an e-mail to

CNNMoney.com.

Amromin added, however, that he concurs with Sialm that over time tax rates can affect asset prices. While he can't say definitively why the 2003 cut had no effect on aggregate valuations in his study, he said he suspects the temporary nature of the cut and the fact that it coincided with the start of the Iraq war may have had something to do with it.

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