Selling Your Business? Read On

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Reduce Taxes When Selling Your Business

As the baby boomer generation prepares to retire, many self-employed business owners will face numerous issues regarding the sale and transition of their businesses. Some of these issues include how much the business is worth, to whom they will sell their business, and how much in capital gains taxes they will have to pay. For example, if the owner of a company started it with $100,000 and sells it years later for $2,000,000, he would face a 15% long-term capital gains tax on the difference of $1,900,000, which amounts to $285,000 (assuming no adjustments to cost basis and state tax on capital gains).

Of course, there are many strategies to minimize taxes, but eventually, if a business has become successful and will be sold for a gain, a significant tax will be due at some point. One often overlooked and misunderstood strategy is the use of tax-loss harvesting in an investment portfolio to offset capital gains tax.

Gains and Losses Within a Mutual Fund

Tax-loss harvesting is often confused with tax efficient investing, so before explaining the difference it is helpful to see how mutual funds operate. An equity mutual fund aggregates funds from investors and purchases a basket of stocks. During the course of a year, the fund will buy and sell numerous stocks. Some will be sold at a gain while others will be sold at a loss. However, when reporting performance, losses are netted from gains and only the net gains (or losses) are reported and passed through to investors via a higher (or lower) net asset value (NAV) per share. Per IRS regulations, realized losses within the fund are not available to individual investors. To realize a loss, the investor would have to sell the mutual fund shares at an NAV less than what they paid for them.

For example, a mutual fund may report a 10 percent return for the calendar year, but there will be stocks within the fund that were sold at a loss. Why? Because it is highly unlikely for every stock within a fund to have a positive return, especially when the fund holds hundreds or even thousands of stocks. So, although a fund may report a positive return, it probably had some internal, realized losses during the year.

Tax-Efficient Investing

It is estimated that 40 percent of a typical mutual fund's returns are taxed away, so any strategy that helps reduce the tax bite and increases returns makes sense. This is where tax-efficient or tax-managed funds help tremendously. Specifically, tax-efficient investing involves deferring large gains and realizing internal losses to offset realized gains inside a mutual fund. So, any investor with a taxable portfolio should seriously consider these tax-managed funds. However, a mutual fund's internal losses cannot be used to offset individual investors' gains. As stated above, the IRS does not allow mutual funds to pass capital losses on to individual investors. So, while tax-efficient mutual funds help reduce taxes, they do not solve the problem of reducing capital gains taxes incurred by individual investors outside of their fund holdings.

Enter Tax-Loss Harvesting

Tax-loss harvesting is the strategy of realizing losses that occur naturally in a portfolio and accumulating these losses to offset future tax liabilities on a dollar-for-dollar basis. The IRS does not limit the amount of capital losses an individual can accumulate during their lifetime, so the benefit of these losses can be substantial. But isn't the goal of investing to make money, not lose it? Absolutely, and a properly structured tax-loss portfolio can achieve positive returns, but with the added benefit of capturing losses. The key is to replicate the investor's asset allocation with individual stocks. By removing the "NAV shell" of mutual funds, investors can recognize losses while maintaining a diversified portfolio and capturing returns commensurate with their allocation. For example, if 20 percent of a client's portfolio should contain large cap stocks, that 20 percent can easily be replicated by buying a representative sample of large cap stocks instead of a large cap mutual fund(s). By doing this, the overall allocation and expected return is maintained, but individual stocks that lose value can be sold to capture the loss. Depending on the size of the portfolio and the aggressiveness of the harvesting, it is not uncommon to generate hundreds of thousands of dollars of losses over several years while maintaining the expected return for the portfolio.

In our example, the business owner who is facing a $285,000 capital gains tax can accumulate enough in tax losses to eliminate that entire tax in as little as four years starting with a portfolio of about $1,500,000. And, using a return assumption of eight percent per year, the portfolio would continue to grow to $1,900,000 in that four-year period. This is a very attractive strategy for a business owner, or anyone facing a large capital gains tax liability in the near future.

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