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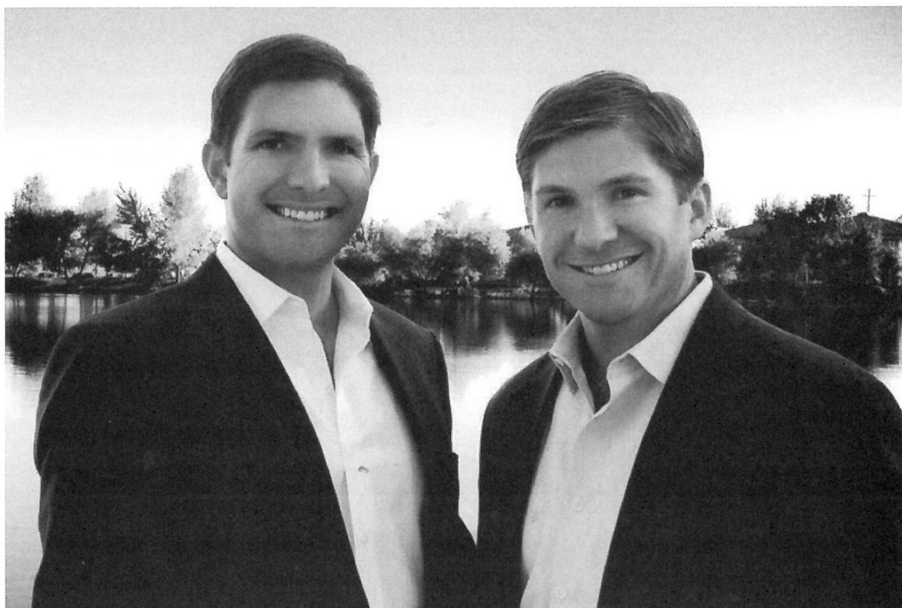
WEALTH ADVISER

Voices: Harvesting Losses to Offset Taxes on a Business Sale

Realizing portfolio declines can help clients cope with capital gains from the sale of a company


Ryan O'Donnell (left) and Mike O'Donnell, co-founders of the O'Donnell Group. PHOTO: O'DONNELL GROUP

Ryan O'Donnell and Mike O'Donnell are co-founders of the O'Donnell Group in Chico, Calif. Voices is an occasional feature of edited excerpts in which wealth managers address issues of interest to the advisory community.

Managing the tax implications of selling a company is one of the most important pieces of a successful exit strategy. In California, where our firm is based, clients could be looking at a personal tax rate of upward of 50% in the year they sell their business. That's why we act, sometimes aggressively, to harvest losses for clients during the years preceding a sale in order to help offset that capital-gains tax burden.

Tax-loss harvesting is a potential silver lining of volatility. Rather than let unrealized losses sit dormant in a portfolio, we can realize them and put them to use in a positive way for our clients.

We begin by identifying funds in a client's portfolio that have sustained unrealized losses. By selling them, the client realizes losses that can be used to counteract the taxable gain on the sale of their business. We then use the proceeds from the sale to purchase a similar fund or funds so the client can take part in the upside when the asset class recovers.

When using this process with clients, it's important to keep the so-called wash-sale rule in mind. You can't sell an investment at a loss and then turn around and buy the same security back within 30 days. That's why we identify a comparable replacement fund that our client feels comfortable buying and holding for the long term.

The wash-sale rule makes this process far more challenging if dealing with individual securities. It's much harder to find two directly comparable stocks than it is to find two similar funds.

Although some wait until year-end to do tax-loss harvesting, it's more efficient to take an active approach to the process. That's because the losses can take place at any time during the year. If markets take a hit in the summer but you wait until December to do this work, prices may have already recovered and any losses in a portfolio will have gone unrealized.

Realized losses carry forward indefinitely from one year to the next. So whether the sale of a business happens this month or three years from now, clients have those losses in their back pocket and can utilize them when the time is right.

Remember, although losses carry forward, they can't be applied retroactively, so it's critical that they be available in the tax year that a sale occurs. Make sure to talk with business-owner clients about their exit plans in order to give yourself enough time to put a strategy like this into place for them.

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