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ATTORNEYS AT LAW

Before You Sell Your Business (Or Any Other Appreciated Asset), Read This!

Although paying taxes is a largely unavoidable part of running a business, you might be pleasantly surprised to learn that there is one common type of tax you can often avoid paying—capital gains taxes. That said, the only way you can avoid paying capital gains taxes (at least legally) is if you plan in advance.

Since we are only a few weeks away from the end of the year, it might seem like it's too late to save on capital gains taxes in 2021, but you may still have time if you act immediately. And if it does end up being too late to avoid paying capital gains this year, at least you'll be prepared for next year and beyond.

The first step in avoiding capital gains tax is understanding exactly how this tax works. With this in mind, we'll outline everything you should know about capital gains taxes so you can put a plan in place to reduce and/or totally eliminate your tax liability on any ongoing or future sales of appreciated assets.

What Is Capital Gains Tax?
Generally speaking, you have a "capital gain" whenever you sell a capital asset for more money than you paid for it. In other words, a capital gain is the profit you make on the sale of a capital asset. Conversely, if you lose money on the sale of a capital asset, it's considered a "capital loss."

What is a capital asset? That's a good question. While the term "capital asset" most often refers to real estate, stocks, bonds, and other types of securities, as the IRS points out below, just about any type of property you own can be considered a capital asset:

"Almost everything you own and use for personal or investment purposes is a capital asset. Examples include a home, personal-use items like household furnishings, and stocks or bonds held as investments," https://www.irs.gov/taxtopics/tc409

Just like the federal government levies a tax on any income you earn during a given year, the IRS also expects a cut whenever you make a profit on the sale of a capital asset. This is where the capital gains tax comes in: the capital gains tax is the federal tax you pay on the profit made from the sale of capital assets.

Capital Assets
As noted earlier, just about anything you own can be considered a capital asset, even artwork, and jewelry. But in the majority of cases, capital assets are assets that you buy and sell as an investment. A few of the most common examples of a capital asset include:

- Stocks
- Bonds
- Real estate
- Businesses
- Jewelry
- Vehicles
- Collectibles

Exclusions To Capital Gains Tax
As a business owner, it's important to note that not every capital asset you sell qualifies for capital gains tax. If your business sells products, your profits from these sales are considered—and taxed as—business income, not capital gains. This is because capital gains taxes are not intended to apply to the sale of assets in the normal course of a business' operation.

For example, if you are in the business of selling smartphones, the profits you make on the sale of smartphones are not subject to capital gains tax. Instead, your profits on the sale of your smartphones are taxed as ordinary business income.

Other assets excluded from the capital gains tax are certain "non-capital assets" which are often intangible assets, such as intellectual property. Specifically, the Tax Cuts and Jobs Act excludes patents, inventions, models, designs, and secret formulas sold after Dec. 31, 2017, from being treated as capital assets for capital-gains tax purposes.

However, there are certain instances when the sale of intangible assets used in a business can be treated as either capital gains or ordinary income. Given this, always consult with us, your family business lawyer, and your certified public accountant (CPA) before you sell or license any intangible asset, especially intellectual property, such as copyrights, patents, and trademarks.

Capital gains on the sale of a primary residence: Since a home is often one of the most valuable assets most families own, capital gains taxes on the sale of your primary residence are taxed differently from the sale of other real estate. Due to a special exclusion, as long as you have occupied the residence for at least two of the last five years, a single taxpayer can exclude up to $250,000 of the gain, while married taxpayers filing jointly can exclude up to $500,000 of the gain.

To be exempt, the home must be considered a primary residency based on IRS rules, and this exemption is only allowed once every two years. Capital gains on the sale of investment properties and other real estate are taxed at the normal short-term or long-term capital gains rates described below. https://www.irs.gov/publications/p523

How The Capital Gains Tax Works
As noted earlier, the capital gains tax applies to profits you make on the sale of capital assets. When you are subject to the capital gains tax, the amount of tax you owe will be based on several factors, including the type of asset you sold, your overall income, how long you owned the asset, and how much money you made on the sale.

Adjusted basis: The IRS uses what's known as an "adjusted basis" to determine whether or not there's been a capital gain on the sale of an asset. In most cases, the adjusted basis of an asset is simply the amount it costs you to purchase the asset.

Included in the basis are any additional expenses you incurred during the purchase or sale of the asset, such as title fees, transfer fees, commissions, shipping, and sales tax. Adding these expenses to the original purchase price of the asset results in a higher adjusted basis, reducing the amount of capital gains taxes owed at the time of sale.

Simply put, you have a capital gain—and will owe capital gains tax—if you sell the asset for more than your adjusted basis. You have a capital loss if you sell the asset for less than your adjusted basis.

Taxes are due upon sale of the asset: It's important to note that you only owe capital gains tax when you sell the asset. For example, if you own a share of stock and it increases in value while inside your portfolio, but you don't sell it, you don't owe any capital gains tax. However, once you sell the stock, any profit you make on the sale must be reported as a capital gain on your tax return.

This factor makes the timing of your sale *extremely important*, as many of the strategies you have to avoid paying capital gains taxes can only be implemented *before* you sell the asset.

Once you've sold the asset, your options for reducing capital gains tax become very limited. We'll address this in more detail below.

Short-Term vs. Long-Term Capital Gains Tax

In addition to the above factors, the amount of capital gains tax you owe also depends on how long you own the asset before selling it. The sale of assets you've owned for a year or less are considered short-term capital gains or losses, while a long-term capital gain or loss occurs when you sell an asset after owning it for more than one year.

Again, the timing of the sale is extremely important, since short-term capital gains are typically taxed at significantly higher rates than long-term capital gains. The IRS makes this difference to discourage short-term trading and encourage long-term investment. Note: there are a few exceptions to the one-year rule, but in general, you'll owe far less capital gains taxes by holding onto an asset for longer than a year before selling it.

Capital Gains Rates for 2021

The following are the capital gains tax rates for 2021, starting with short-term rates:

Short-term capital gains tax rate: Short-term capital gains are taxed at ordinary income tax rates. For 2021, the ordinary income tax rates are 10%, 12%, 22%, 24%, 32%, 35%, and 37%, depending on your taxable income and tax filing status, as illustrated below:

Tax Rate	Income (single filers)	Income (Married filing jointly)
10%	$9,950	$19,900
12%	$9,950	$19,900
22%	$40,525	$81,050
24%	$86,375	$172,750
32%	$164,925	$329,850

35%	**$209,425**	**$418,850**
37%	**$523,600**	**$628,300**

Long-term capital gains tax rate: Long-term capital gains are taxed at basic capital gains tax rates. For 2021, those rates are 0%, 15%, and 20%, depending on your taxable income and tax filing status, as illustrated below. Note: since the lowest capital gains tax rate is 0%, in some cases—if your income is low enough—you may end up paying no capital gains tax at all.

Filing status	**Income for 0% tax rate**	**Income for 15% tax rate**	**Income for 20% tax rate**
Single	**Up to $40,400**	**$40,401 - $445,850**	**$445,851+**
Head of Household	**Up to $54,100**	**$54,101 - $473,750**	**$473,751+**
Married Filing Jointly	**Up to $80,800**	**$80,801 - $501,600**	**$501,601+**
Married Filing Separately	**Up to $40,400**	**$40,401 - 250,800**	**$250,801+**

Legislative update: In September 2021, the House Ways and Means Committee proposed an increase in the top capital gains tax rate from its current 20% to 25%. If the provision passes as currently written, it will apply retroactively to transactions made after Sept. 13, 2021. Sales that are finalized prior to that date will be eligible for the current tax rates up to 20%, while sales that occur after that date will be subject to the new tax rates up to 25%. However, as of mid-November 2021, none of the proposed increases have been passed into law. Stay tuned for updates on the proposed legislation.

How To Avoid Capital Gains Taxes

As we mentioned at the beginning of this article, with proper pre-planning, you can often significantly reduce or totally eliminate the amount of capital gains taxes you owe on the sale of appreciated assets. This includes the sale of your business. While many of the strategies for reducing capital gains taxes are quite complex and will require the guidance and support of your family business lawyer and CPA, here are a few of the simplest options for avoiding capital gains tax.

1. Don't wait until the sale to act: The most important factor in avoiding capital gains tax is to plan ahead and take action before you make the sale. This point cannot be stressed enough, as most of the strategies for avoiding capital gains tax are only available if they are implemented prior to the asset being sold. Once the sale happens, it's too late and you'll be left with few tax-saving options, most of which will merely reduce the amount of capital gains tax you owe, rather than completely eliminating it.

2. Hold onto the asset: Given the big difference between short-term capital gains tax rates and long-term rates, you should obviously do your best to hold onto the asset for at least one year. In some cases, if your income is low enough, you can qualify for a rate of 0% on the sale. In addition, by living in your home for at least two years before you sell it, you can take advantage of the hefty primary residence exemption of $250,000 for single taxpayers and $500,000 for married taxpayers filing jointly.

3. Take advantage of tax-deferred retirement plans: By investing in tax-deferred retirement plans, such as a 401(k), 403(b), or IRAs, your money can grow without being subject to immediate taxation. You can also buy and sell other investments within your retirement account, and those transactions won't trigger capital gains tax, either.

4. Offset capital gains with capital losses: If you experience a capital loss on one of your investments, you can use that loss to offset your capital gains on other investments along with a portion of your ordinary income. Specifically, a married couple filing jointly can use up to $3,000 per year in realized capital losses to offset capital gains tax or taxes owed on ordinary income. Any amount left over after that can be carried over to future years.

5. Sell when your income is lowest: Since the amount of capital gains tax you owe depends on your overall income, it makes sense to wait and sell your investments and other appreciated assets when your income is at its lowest. And since you typically have a higher income while you are working, you may want to wait until you retire to sell certain assets.

Enlist Our Support To Maximize Your Tax Savings

The above five strategies are just a few of the numerous options available to avoid capital gains tax. However, many of the alternative options are complex and will require the support of us, your family business lawyer and CPA working together to strategize and implement on your behalf. If you are going to have a big tax bill, it's likely worth it. It's imperative that you take action as quickly as possible to ensure that whatever actions need to be taken can be planned and executed before you make the sale—and before the end of the year.

If you are planning to sell any assets this year that will result in significant capital gains or loss, don't wait—contact us, your family business lawyer immediately to discuss your options. Capital gains tax is one of the few taxes that you can avoid paying, but only if you plan ahead and plan wisely. Contact us today to schedule your appointment.

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