

Tax advantage

Section 338(h)(10) can help S corp buyers and sellers

If you're planning to sell a business arranged as a subchapter S corporation, a provision of the federal tax code can make you a more appealing target for buyers. Even better, it could boost your sale price.

Why buyers like the code

S corporations don't pay income taxes. Instead, the company's income or losses are distributed through its shareholders, who in turn report income or losses on their individual income tax returns. This fact can potentially complicate the sale of an S corporation.

Internal Revenue Code Section 338(h)(10), however, enables a *stock* sale of an S corporation to be taxed as if the transaction were an *asset* sale. Asset sales offer several advantages. For one, the buyer can take a "stepped-up" tax basis, which means it can significantly raise the stated value of the seller's assets. Greater asset value, in turn, enables a buyer to claim more depreciation on its to-be-acquired assets and, therefore, take a larger, current tax deduction.

What's in it for sellers

This advantageous tax situation puts selling S corporations in an excellent negotiating position. Buyers must obtain the approval of the selling company's shareholders to structure a deal that includes a 338(h)(10) election. And buyers typically are willing to agree to a higher purchase price in exchange for shareholder cooperation.

In a 2005 study analyzing S corporations, Merle Erickson, an accounting professor at the University of Chicago's Booth School of Business, and Shiing-wu Wang, a professor at the University of Southern California's Marshall School of Business, estimated that the tax benefits of S corporation acquisitions total, on average, approximately 12% to 17% of the deal's value.



For example, when Coca-Cola Enterprises acquired the S corporation Herb Coca-Cola Inc. in 2001, it paid Herb's shareholders an extra \$100 million to approve the 338(h)(10) election. Coca Cola reportedly valued the tax benefits of the election at \$145 million, thus paying Herb shareholders 70% of the total tax benefits.

Despite these kinds of benefits, many S corporation sellers are unaware of or ill-informed about the tax code provision. Unfortunately, sometimes buyers use seller ignorance to take the deduction without offering a higher acquisition price in return.

Know your advantage

Realizing the tax advantages of Section 338(h)(10) is a complex process. So it's essential to work with experienced advisors who are knowledgeable about tax issues. They can help you determine if your business is eligible and ensure you get an equitable share of any tax benefits a buyer derives from the acquisition.