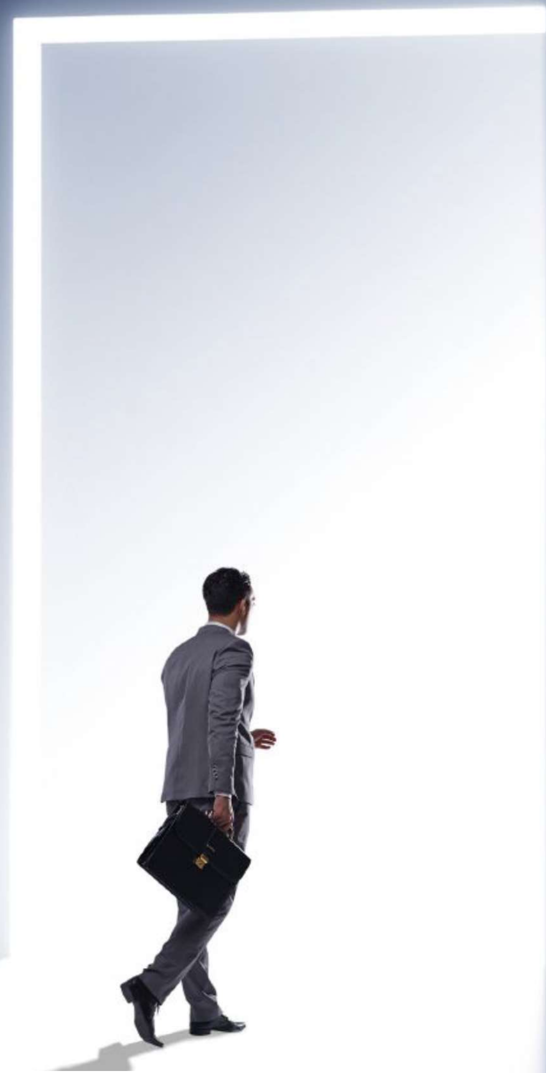
Planning for Their Exit:

Advising Business Owners on an Exit in a Heightened Interest Rate Environment



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Much has been written recently about rising interest rates and the impact it can have on various wealth and tax planning strategies. For the closely held business owner who is interested in selling their business—which is often their most valuable and prized asset—it is important that their advisors understand how interest rates might affect the exit plan. This article examines four primary strategies a business owner may use when selling their business, namely, selling to a third party, to insiders, to employees, or to family members; how the current rate environment might impact each strategy; and the planning opportunities that advisors and their business-owning clients should consider when planning for a business owner's exit.[1]

INTEREST RATES AND CLOSELY HELD BUSINESSES GENERALLY

In response to the highest inflation in 40 years, the Federal Reserve began raising interest rates in March 2022 and continued to do so until late 2023 before pausing further rate hikes and indicating an openness to lowering rates again over time. Closely held business owners, like others, have felt the impact of rising rates in various aspects of their lives, but perhaps most significantly in their businesses.

The nature of the business and the industry itself generally determine the extent to which any particular business owner is affected by interest rates. Some industries are especially susceptible to rate movements, including those that rely heavily on loans for acquisition, expansion, and operation, as well as companies in every industry that are particularly rate sensitive by virtue of their leveraged capital structures.

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1 Business owners might also use gifting or charitable techniques to transition their businesses, but those are outside the scope of this article, which focuses on sale strategies in particular.

Companies that are rate sensitive may be particularly impacted by these increases in their cost of capital, cash flow, and profits, among other things. For those contemplating an exit, rising interest rates could in turn translate to lower valuations in the marketplace, as the rising rates could exert downward pressure on multiples and thus the price a buyer is willing to pay for an acquisition. Despite this, there may be silver-lining planning opportunities regardless of whether a business owner is considering a sale to a third party, insiders, employees, or family members.

SALE TO A THIRD PARTY

Business owners who decide to sell to an outside third party generally want to maximize profit and therefore are most likely to consider selling when a buyer is willing to pay maximum value. Third-party buyers might be considered strategic buyers (e.g., a competitor) or financial buyers (e.g., a private equity fund). Strategic buyers in particular may be willing to pay a premium where they can create synergies that substantially increase their bottom line.

Generally, sales to strategic buyers are less likely to be affected by increased interest rates than sales to financial buyers. While strategic buyers may utilize leverage in a transaction, as long as the cost savings created by the merger are greater than the higher interest expense, it may still be a worthwhile acquisition. Financial buyers, on the other hand, typically finance a large portion of the acquisition cost, so a sale to a financial buyer is more likely to be affected by higher interest rates.

Creativity in the terms of the deal could counterbalance a softer market and price reductions for business owners selling to a third party. While a financial buyer may offer less cash up front, they may be willing to structure the deal to include other features that could be beneficial to the owner, especially over the long term. This could include receipt of rollover equity, which could provide tax and other planning opportunities.

Rollover equity, often a feature of deals with private equity firms, is the amount a business owner-seller reinvests from the sale into the acquiring company or a newly created venture. Depending on structuring, this can be beneficial to the seller not only from an income tax standpoint, as they may be able to defer capital gains on the portion of the sale the rollover represents, but also in estate tax planning. Under current law, each person has an exemption from the gift and estate tax, which they can use during their lifetime by making tax-free gifts. In 2024, this exemption stands at a historic high of $13.61 million per person, or $27.22 million for a married couple.[2] A business owner who wants to take advantage of this exemption before it is set to be reduced in 2026 could use some or all of their rollover equity for gifting purposes.[3] By doing so, they could remove that asset from their taxable estate, and importantly, remove any growth and appreciation in the value of the rollover equity, which might be multiples of its value when the transaction closes. This can be a powerful and effective estate tax planning strategy.[4]

For this type of planning, business owners might consider using trusts rather than direct gifts to individuals. Certain types of trusts, including spousal lifetime access trusts (SLATs) and dynasty trusts, can provide an array of tax and other benefits, especially when established in favorable jurisdictions like Delaware. Trusts are discussed further below in the context of intrafamily transactions.

SALE TO INSIDERS

In lieu of selling to a third party, business owners might be inclined to sell to insiders, including management or key employees of their business. Sales to insiders are often appealing because they can allow for business continuity and promote employee engagement. Importantly, they also eliminate the need to find an external buyer in what could be a more challenging marketplace.

Despite these benefits, elevated interest rates may create financing challenges when selling to insiders. Key employees frequently lack sufficient liquidity to pay full price for the business, which means they would need to borrow funds, and they are often highly sensitive to the cost of capital. While the business may have more capacity to borrow as part of a stock redemption, it may not be able to raise capital to purchase the entirety of the owner's interest.

With limited external financing options, an owner who wants to sell to insiders could consider structuring their sale as either fully or partially seller financed. Generally, a seller-financed transaction is one in which the business owner takes back a note from the buyer in exchange for the interest they are selling. This could be for all or part of the acquisition cost. While the note would be interest bearing, its rate and terms may be better than the buyer could find in the commercial market. For buyers, this means an alternative, and perhaps more favorable,

2 Rev. Proc. 2023-34, 2023-48 I.R.B. 1287.

3 The current law is scheduled to sunset after December 31, 2025, at which point the exemption would revert to its 2017 level. This may be as low as $6.5 million per person.

4 In advance of a sale to a third party, a business owner might also engage in pretransaction planning by transferring their business equity to a family member or a trust before the sale. This too can be an effective use of their lifetime exemption and affords an opportunity to take advantage of potentially lower business valuations and discounting opportunities.

financing option that could allow the seller to secure a higher sale price than they might otherwise receive in an up-front, all-cash sale to insiders.

A seller-financed transaction may also have income tax benefits. For tax purposes, the seller may be able to treat part or all of the transaction as an installment sale, in which case they would recognize taxable gain over time rather than in the year of the transaction.[5] This would effectively allow the seller to defer their income tax liability into future years.

Receipt of sale proceeds on an installment basis could also be beneficial as a financial planning tool for a retiring business owner. Although this might mean forgoing an opportunity to invest more of the sale proceeds up front, installment payments could serve as an annuity to support their lifestyle going forward, providing a steady stream of income into their retirement.

SALE TO EMPLOYEES

Business owners who sell their business to employees often do so in the form of an employee stock ownership plan (ESOP), which is a tax-qualified retirement plan that may invest in employer securities.[6] ESOPs tend to be a popular exit strategy due to the potential tax and other benefits they provide to both the sponsoring business and the selling shareholder.

In a higher interest rate environment, ESOPs may be particularly compelling exit strategies, especially if using leverage as part of the transaction.[7] In a leveraged ESOP, in which the ESOP borrows money to purchase the shares from the business or from a bank, the business makes annual cash contributions or pays dividends to the ESOP at least equal to the principal and interest due on the loan. The company distributions are then used by the ESOP trustee to repay the loan.

From a tax standpoint, this can be beneficial to the company sponsoring the ESOP. Each year, a company can deduct contributions it makes to an ESOP that are used by the ESOP to make interest payments to service its debt. If the company is a C corporation, it can also deduct contributions made for principal payments, subject to certain limitations.[8] In effect, this means that the business may make tax-deductible contributions equal to the amount of the loan, effectively deducting the cost of the debt related to the ESOP transaction.

Many business owners are also drawn to ESOPs because of the potential for income tax deferral on the sale, which is known as a § 1042 rollover in reference to the relevant section of the Internal Revenue Code.[9] In short, if certain requirements are met, a shareholder of a C corporation may defer gain recognition on their sale to an ESOP if they reinvest the sale proceeds into so-called qualified replacement property (QRP), which would include stocks and bonds of US operating companies. This allows the shareholder to defer their tax liability until such time as they dispose of their QRP, which could be years in the future. If a business owner holds their QRP until death, the basis in the QRP—previously carried over from the sale to the ESOP—would be adjusted to fair market value at that time. Where the property has appreciated, this adjustment is a basis step-up, and it can effectively eliminate the unrealized gain, passing the stepped-up basis to the owner's heirs, which can reduce or eliminate the income or capital gains tax payable by the owner's heirs.[10]

Higher interest rates could impact those planning to do a § 1042 rollover in several ways, but particularly in connection with their selection of QRP. If a seller is open to a passive investment approach and is planning to hold the QRP for a long period, and perhaps until their death, they may benefit from the recent increase in rates, as corporate bonds could pay higher interest than in the recent past, providing an increased income stream to the owner after the sale.

While a buy-and-hold strategy may benefit from higher rates, other strategies used in § 1042 transactions may be less compelling. To monetize their transaction, some business owners implement a strategy whereby they acquire floating rate notes (FRNs) as QRP and use them as collateral for a loan, the proceeds of which they then use to purchase a portfolio of diversified stocks and bonds. In effect, this allows for active investment management while maintaining the tax deferral provided by I.R.C. § 1042. In a more volatile rate environment, however, this strategy could prove riskier, since FRNs (as their name suggests) can be closely linked to the movement of interest rates. If rates decline, an owner could find themselves exposed to a margin call, jeopardizing the success and benefits of this strategy.

SALE TO FAMILY MEMBERS

5 I.R.C. § 453.

6 *Id.* § 409(a).

7 Prior to pursuing an ESOP, a business would likely conduct a feasibility study to determine its ability to take on debt as part of a leveraged ESOP. The increased cost of capital may make a leveraged ESOP unrealistic or unsustainable for certain companies.

8 I.R.C. §§ 404(a)(9), 415(c). S corporations generally do not benefit from the same treatment as C corporations in this regard, and deductions may be more limited in connection with interest and principal payments on the loan.

9 I.R.C. § 1042.

10 *Id.* § 1014.

Owners of multigenerational businesses often consider a sale to family members for business or legacy purposes or perhaps due to emotional attachment to their business. Regardless of their reason, an intrafamily sale can not only present opportunities but also challenges.

In the current environment, a sale to family members could benefit from downward pressure on business valuations. Although a lower valuation is less desirable when selling to a third party, it may be advantageous when selling to family members. In short, a lower fair market value for the business, as determined by a qualified appraisal, could make it more affordable for a family member to purchase the business than it would have been when rates were lower and valuations higher.

Although valuations might be more favorable, higher interest rates could counter the benefits of a lower valuation. Business sales to family members are often done on an installment basis, with the owner taking back a promissory note in exchange for the business interest sold. To be respected as a bona fide sale, these notes must carry a minimum interest rate, known as the applicable federal rate (AFR), which is set on a monthly basis.[11] Rising rates have caused a corresponding increase in the AFR, making intrafamily sales less compelling as they become more expensive for the acquiring family members. However, additional planning could help with this as well.

With the historically high lifetime gift and estate tax exemption, a business owner has an opportunity to transfer significant wealth to family members, which could include assets outside of their business. If they were considering selling a business to family members and the family lacked the liquidity to make the higher interest payments on the note, the owner could make cash gifts to help them. If the business owner themselves lacked liquidity, they could elect to either forgive interest due on the note over time or, if interest rates decline in the coming months and years, refinance the note, reducing the interest payable and making the transaction more sustainable for their family. This would provide additional flexibility if rates fluctuate.

In the family context, it is often advisable for an owner to utilize trusts for their business and personal planning. In lieu of a sale to family members directly, a business owner might sell their business to a trust for their family's benefit. If the sale occurred between the owner and a grantor trust for income tax purposes, the business owner, as the grantor of the trust, would remain liable for payment of income taxes generated by trust assets.[12] From a wealth planning standpoint, this can be beneficial, as income taxes paid by the grantor on behalf of the trust are not generally treated as taxable gifts.[13] In addition, while trusts are taxed on income at the compressed trust tax brackets (meaning that a trust with income of approximately $15,000 per year in 2024 pays taxes at the top 37 percent marginal rate), an unmarried taxpayer does not reach the top marginal tax bracket until they make over $600,000 in income annually.[14] If the trust is structured as an intentionally defective grantor trust, the income tax consequences and estate tax consequences can be separated, such that the grantor remains liable for income taxes, and the assets (including growth and appreciation) are excluded from the grantor's estate and not subject to estate taxes at the business owner's death.

CONCLUSION

Regardless of whether a business owner is planning for a sale to a third party, insiders, employees, or family members, their advisors should understand how the current rate environment could impact their transaction and ultimately what strategies might be worth implementing. With thoughtful and careful planning in collaboration with their advisors, an owner can maximize their exit despite potential headwinds they may be facing and position themselves and their families for long-term success in the years to come.[15]

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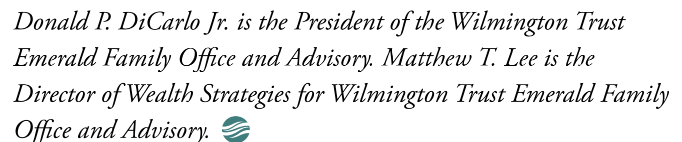

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11 *Id.* § 1274.

12 *Id.* §§ 671–679.

13 Rev. Rul. 2004-64, 2004-2 C.B. 7.

14 *See*, e.g., Rev. Proc. 2023-24, 2023-48 I.R.B. 1287.

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