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Seller Notes and Rollover Equity: How Owners Stay In

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Two ways an owner stays in the deal

Most private company sales do not pay the seller 100% in cash at closing. Part of the price is often deferred or reinvested, and the two most common instruments for that are the seller note and rollover equity. They look similar on a sources-and-uses table. They are very different positions to hold.

- With a **seller note**, the seller becomes a **lender** to the buyer. The return is contractual interest and principal. Upside is capped; downside is the buyer's credit risk.
- With **rollover equity**, the seller becomes a **co-owner** of the buyer. The return is whatever the equity is worth at the next exit. Upside is open; downside runs to zero.

Feature	Seller note	Rollover equity
What the seller holds	A debt claim on the buyer	Shares or units in the buyer's holding entity
Return	Fixed or floating interest plus principal	Share of future equity value and any distributions
Ranking	Usually subordinated to senior lenders; ahead of all equity	Behind all debt; may also be behind preferred equity
Control	Covenants and default remedies only, usually limited by intercreditor terms	Minority governance rights negotiated in the equity documents
Timing of cash	Scheduled payments, often after a delay	Mostly at the next sale or recapitalization
Tax outline	Often reported under the installment method	May qualify for nonrecognition if the statutory conditions are met

This article describes mechanics, published tax provisions and SBA rules from the seller's side. It is not legal or tax advice. Individual facts (entity type, state law, the buyer's structure) change the answers, and a seller should have their own counsel and tax adviser.

How a seller note works

A seller note is a promissory note from the buyer (usually the acquisition vehicle) to the seller for part of the purchase price. The terms that matter most:

- **Principal and rate.** The rate must be set with tax rules in mind (see the next section).
- **Amortization and maturity.** Many notes have an initial period of interest only, or no payments at all, before principal amortizes.
- **Subordination.** Senior lenders almost always require the seller note to be subordinated, both in right of payment and in any lien. A subordination agreement typically lets the senior lender block payments on the note while a senior default exists.
- **Standstill.** The seller agrees not to sue, accelerate or enforce for a period after a default, so the senior lender controls any workout.
- **Security and guarantees.** The note may be unsecured, secured by a junior lien, or guaranteed by the holding company.

- **Offset.** Buyers often ask for the right to reduce note payments by the amount of indemnification claims under the purchase agreement. For the seller, this turns the note into a partial indemnity escrow.

Illustrative example (fictional): a seller note term sheet

Bluewater Fabrication is a fictional precision machining company sold for $12.0 million. All terms below are invented to show the shape of a term sheet, not market norms.

#	Term	Fictional value
1	Issuer	Bluewater Holdings LLC (buyer's acquisition vehicle)
2	Principal	$1,200,000 (10% of price)
3	Interest	Fixed rate, set at or above the applicable federal test rate (adviser to confirm)
4	Payment schedule	Interest only for 24 months, then 36 equal monthly installments
5	Maturity	60 months from closing
6	Ranking	Subordinated to senior credit facility in right of payment
7	Payment blockage	Senior lender may block payments during a senior default
8	Standstill	180 days after a note default before the seller may enforce
9	Security	Unsecured; holding company guarantee
10	Offset	Buyer may offset finally determined indemnity claims only
11	Acceleration	On sale of the company or refinancing of senior debt
12	Prepayment	Permitted without penalty

The tax outline owners ask about: installment sales

The Internal Revenue Code defines an installment sale as "a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs," and the general rule is that income from an installment sale is taken into account "under the installment method" (26 U.S.C. 453). In plain terms, gain can be recognized as payments are received rather than all at closing.

The exceptions and complications are where advisers earn their fees. IRS Publication 537 (for 2025 returns) sets out several that matter in business sales (IRS Publication 537):

- **Depreciation recapture** must be reported in the year of sale, even if no payment is received that year; only gain above the recapture amount is reported under the installment method. Section 453(i) contains the statutory rule.
- **Inventory** sold in the regular course of business does not qualify, and the statute separately excludes dealer dispositions.
- **Stock or securities traded on an established securities market** cannot be reported on the installment method.

- **Sale of a business** is treated as a sale of each asset, and the publication has separate sections on allocating the price among assets and on selling a partnership interest.
- **Unstated interest.** If a contract provides little or no interest, part of the principal may be recharacterized as interest or original issue discount. The test rate is based on the applicable federal rate (AFR), which the IRS publishes monthly. The publication also describes a 9% cap on the test rate for certain seller-financed sales below a dollar threshold that it states for the year.

What a seller should take from this: whether a note defers tax, and how much, depends on the type of assets sold, how the price is allocated, and how the note is priced. None of it should be assumed from a term sheet.

How rollover equity works

In a rollover, the seller reinvests part of the sale value into the buyer's holding entity instead of taking cash. In the fictional Bluewater deal, suppose the sponsor invests $3.6 million of equity and the seller rolls $1.2 million: the seller would own 25% of the holding entity's equity ($1.2 million out of $4.8 million), if both invest in the same security at the same price.

Three questions decide whether a rollover is what it appears to be:

1. **Same security or not?** If the sponsor holds preferred units with an accruing return and the seller holds common, the seller's 25% is a residual claim behind the preferred. The same percentage can be worth very different amounts.
2. **Same price?** The rollover should be valued at the same enterprise value as the cash purchase. If the sponsor buys in at a lower implied price (for example through fees or a separate "sweet equity" pool), the seller's stake is diluted from day one.
3. **What rights come with it?** Minority holders depend on contractual protections: information rights, a board or observer seat, consent rights over related-party transactions, tag-along rights, and the terms of drag-along and any put or call.

The tax outline: nonrecognition, if conditions are met

Rollovers are often structured to avoid immediate tax on the rolled portion. The statutory bases are short:

- **Partnerships (including most LLCs taxed as partnerships).** "No gain or loss shall be recognized to a partnership or to any of its partners" on a contribution of property in exchange for an interest in the partnership, with an exception in section 721(b) for partnerships that would be investment companies if incorporated (26 U.S.C. 721).
- **Corporations.** "No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c))" (26 U.S.C. 351). Section 351(b) addresses what happens when the transferor also receives "other property or money."

Two items to raise with counsel rather than assume: whether the "control" condition is satisfied by the group of transferors in a corporate structure, and how cash received alongside the rolled equity (boot) is taxed. Rollover structures are designed around these rules, and the buyer's preferred structure may not be the one that suits

the seller's tax position.

When lenders constrain the structure: SBA 7(a) rules

Some buyers cannot offer these structures at all. Individual buyers financing with an SBA 7(a) loan are bound by SOP 50 10, version 8.1, effective October 1, 2026 (SBA SOP 50 10 page). Appendix 15 sets the following limits (SOP 50 10 8.1):

- **Seller notes as equity only on full standby.** "Seller debt that is subordinated to the Lender and on full standby (no payments of principal or interest for the term of the 7(a) loan) may be considered as equity for SBA's purposes." Seller debt is a "limited" equity source; limited sources, "individually or in the aggregate, may provide no more than half of the required Equity Injection."
- **Paying seller notes count against the deal.** Seller debt that is not on full standby is included in total debt, which "is limited to the business valuation amount and must be supported by the Debt Service Coverage of the Applicant."
- **Refinance after 36 months.** Seller debt "is eligible to be refinanced after it has been in place and current for 36 months."
- **No earn-outs.** "Seller earnouts are prohibited," though buyer rebates based on performance are allowed. (An earn-out is contingent consideration paid if targets are met.)
- **No seller stake in most deals.** In an Initial Acquisition or Business Expansion, "the seller... may not remain as an officer, director, stockholder, or employee of the business," except as a consultant "for a period not to exceed 24 months (in aggregate, including any extensions)." Sellers can remain owners in an Owner Buyout (Partial Change).
- **No holdco rollover workaround.** The SOP states that "multi-step partial changes of ownership are not eligible," describing structures where existing owners and new owners form a new entity that becomes the 100% owner of the operating company.

The practical result: an owner selling to an SBA-financed buyer in a full acquisition will usually receive cash plus, at most, a standby or modest amortizing note, and no rollover. An owner who wants to keep equity is generally looking at a sponsor, an independent sponsor, or a partial sale.

Alignment benefits and the risks on each side

For the seller

- **Concentration.** Rolling equity or holding a note leaves part of the owner's wealth tied to the same business they just sold, now with more debt.
- **Subordination.** A seller note ranks behind senior debt. In stress, payments can be blocked and enforcement delayed by the standstill.
- **Buyer credit risk.** The note is only as good as the acquisition vehicle's cash flow.
- **Minority position.** Rollover holders rarely control timing of exit, distributions or future acquisitions.
- **Offset.** If the note can be reduced by indemnity claims, part of the price is exposed to post-closing disputes.

For the buyer

- **Less cash at closing** and, with a note, a lender that is patient by contract.
- **Retained knowledge and alignment** from a seller who still has money at stake.
- **Costs:** dilution, governance complexity with a minority holder, and a creditor (the seller) whose interests may diverge from the sponsor's in a downturn.

Illustrative downside case (fictional)

Continue the Bluewater example: $12.0 million price, $6.0 million senior debt, $1.2 million seller note, $4.8 million total equity (seller 25%). Five years later:

Scenario	Enterprise value at exit	Senior debt outstanding	Seller note outstanding	Equity value	Seller's 25%
Plan	$16.0M	$3.0M	$0 (repaid)	$13.0M	$3.25M
Flat	$11.0M	$4.0M	$0.6M	$6.4M	$1.6M
Stress	$7.0M	$5.0M	$1.2M (payments blocked)	$0.8M	$0.2M

All figures are invented and ignore fees, taxes and preferred returns. The pattern is the point: in the stress case the note still has a claim ahead of equity, but the rollover is nearly wiped out. A seller holding both is exposed twice to the same downturn.

A negotiation worksheet for owners

Use this as a list of items to discuss with advisers. The "fictional example" column shows one possible answer, not a recommendation.

Item	Question to settle	Fictional example
Collateral and guarantee	Is the note secured or guaranteed, and by whom?	Holdco guarantee, no lien
Payment blockage	How long can the senior lender block payments, and how often?	Up to 180 days, once per year
Acceleration	Does the note become due on a sale, refinancing or change of control?	Yes, on any of the three
Interest on blocked payments	Do missed payments accrue interest or compound?	Accrue at the note rate
Offset	Only for finally determined claims, or any asserted claim?	Finally determined only
Information rights	Monthly financials? Annual budget?	Quarterly financials, annual budget
Security of rollover	Same class and price as the sponsor?	Same class, same price per unit
Tag-along	Can the seller sell alongside the sponsor on the same terms?	Yes

Item	Question to settle	Fictional example
Drag-along	Can the seller be forced to sell, and on what minimum terms?	Yes, same price and form of consideration
Put rights	Can the seller require a buyback (for example on death or disability)?	Put at fair value on death or disability
Valuation at rollover	Is the rollover priced at the same enterprise value as the cash purchase?	Yes, documented in the purchase agreement
Related-party protections	Consent for transactions between the company and the sponsor?	Consent required above a threshold

What a sourcing team should note about owner intent

Whether an owner wants to stay in, and how, shapes which buyers can compete. Before a first meeting, a sourcing team can record observable context, labelled as context rather than conclusion:

- **Tenure and role.** How long the owner has run the business and whether they are still the operator, from registry filings, licences and the company's own pages.
- **Succession visibility.** Whether a family member or senior employee appears in a management role. Absence of evidence is not evidence of no successor.
- **Stated intent.** Anything the owner has said publicly about stepping back, and when.

These are prompts for a conversation, not predictions. The succession and ownership overview and the founder succession transitions thesis cover the wider context. What an owner actually wants (cash now, a note, a stake, a role) is learned by asking.

Docket's agents can record facts like tenure and role as typed answers, each with the quoted page it came from, and leave unknowns visibly open.

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