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# The Cares Act: The Affiliation Rules and How They Impact Eligibility Under the Paycheck Protection Program

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*The Coronavirus Aid, Relief, and Economic Security Act (CARES Act), a sweeping third-wave relief package in response to the COVID-19 pandemic, became law March 27. To read the full overview of the bill, [click here](#).*

One of the largest sections of the CARES Act, the Payroll Protection Program, authorizes up to \$349 billion in loan commitments under the Small Business Administration's 7(a) loan program. Businesses are now wondering if they are eligible for these covered loans.

Prior to the passage of the CARES Act, the recipient of an SBA loan had to be a "small business concern", measured by variables like the number of employees or the average annual receipts of the business. In addition, under the SBA affiliation rules, all affiliates of the business concern were also counted to determine the applicable small-business size.

Under the CARES Act, small businesses are still eligible under the previous standards. However, the CARES Act expands eligibility for loans under the Payroll Protection Program (a "covered loan") during the covered period of February 15, 2020 through June 30, 2020 to any business concern, nonprofit organization, veterans organization or tribal business concern that employs not more than the greater of (1) 500 employees whose principal place of business is in the United States<sup>[1]</sup> or (2) if applicable, the size standard in the number of employees established by the SBA for the industry in which the business concern operates.<sup>[2]</sup> Businesses also may be eligible by satisfying the typical SBA 7(a) employee-based or revenue-based size standards or the alternative size standard. Hotels, restaurants, bars and other businesses under the accommodation and food services sector are also eligible as long as (a) they do not have more than 500 employees whose principal place of business is in

the United States per each physical location and (b) they are assigned a North American Industry Classification System (NAICS) code beginning with 72. Businesses under the Accommodation and Food Services sector in the NAICS beginning with 72 are (“the Accommodation and Food Services Sector Businesses”): hotels and motels, casino hotels, bed-and-breakfast inns, all other traveler accommodation, RV parks and campgrounds, recreational and vacation camps, rooming and boarding houses, dormitories and workers’ camps, food service contractors, caterers, mobile food services, drinking places (alcoholic beverages), full-service restaurants, limited-service restaurants, cafeterias, grill buffets and buffets, snack and non-alcoholic beverage bars.[\[3\]](#)

## The Affiliation Rules

While a business on its own may qualify for an SBA loan under the expanded eligibility rules, the SBA’s affiliation rules still apply, unless waived under the CARES Act as set forth below. Under the affiliation rules, business concerns and other entities or individuals are deemed to be affiliates of each other if (1) one business controls or has the power to control another or (2) a third party (or parties) controls or has the power to control both businesses.[\[4\]](#) Control may exist through ownership, management, or other relationships or interactions between the parties. Below are examples of when the SBA’s affiliation rules may apply to an applicant of a covered loan:

- If a person (which we use to refer to an entity or individual throughout this summary) owns more than 50% of the voting stock of the applicant and other companies, then all of the companies are considered affiliates and will be aggregated in determining the size of any one of them.
- If a person owns and controls, or has the power to control, a block of voting stock of the applicant that is large when compared to all other outstanding blocks of stock (such as the person owns 40% of the voting stock with the next largest share at 2%), then the person and the applicant are affiliates and all other companies controlled by the person are considered affiliates of the applicant.

- If two or more persons each owns or controls, or has the power to control, less than 50% of the voting stock of the applicant and (i) the minority holdings are all approximately equal in size, and (ii) all of the minority holdings taken together are large compared to other stock holdings, then each person will be considered an affiliate of the applicant and all companies controlled by each person.
- If one or more officers, directors, managing members or general partners who control the applicant, control the Board of Directors or the management of another company, then the applicant and the company plus all other companies controlled by such company are affiliates. In its determination, the SBA considers negative control such as having veto power over certain decisions.
  - Control over management includes management of the applicant's business concern through a management agreement. Unless the applicant's business concern has "meaningful oversight" over the management company's activities under the management agreement. "Meaningful oversight" by the applicant business concern means involvement in the decisions made concerning the operation of the business. This includes a management agreement that provides for the applicant business concern to do all of the following: (i) approve the annual operating budget; (ii) approve any capital expenditures or operating expenses over a significant dollar threshold; (iii) have control over the bank accounts; and (iv) have oversight over the employees operating the business (who must be employees of the applicant business concern).
- If individuals or firms have an identical business or economic interests, such as family members or firms that have contractual relationships, then they may be treated as affiliates.
- If the applicant is economically dependent on another person, such as through subcontracts, licenses, or significant loans or guarantees, then the applicant will be affiliated with the

person on which it is dependent.

- If the applicant is a newly organized company organized by the former officers, directors, principal stockholders, managing members or key employees of another company; and the former company furnishes the applicant with contracts, financial or technical assistance, indemnification, or other facilities, then the applicant and the older company are affiliates.

It is important to note that, for purposes of the affiliation rules, the SBA treats stock options, convertible securities and merger agreements as though the rights granted in those instruments have been exercised.

## Waiver of the Affiliation Rules

The CARES Act waives the affiliation rules with respect to eligibility for:

- Any business concern with no more than 500 employees at each physical location that is assigned a NAICS code beginning with 72 (see the Accommodation and Food Services Sector Businesses list above);
- Any business concern operating as a franchise that is assigned a franchise identifier code by the SBA; and
- Any business concern that receives funding from a Small Business Investment Company (SBIC) licensed under section 301 of the Small Business Investment Act of 1958.[\[5\]](#)

The waiver should help businesses that are structured with more than one business concern. For instance, a business concern that has separate limited liability companies for its hotels should be able to have each limited liability company apply for funding under the Payroll Protection Program, as each entity is limited to one covered loan, so long as the limited liability company applying for funding does not have more than 500 employees at its location. However, if the hotels are owned by the same business concern, the business concern may not be eligible to receive funds under the Payroll Protection Program if any of its hotels have more than 500 employees.

Similarly, for franchises, as long as the franchise is on the SBA Franchise Directory,[\[6\]](#) they should benefit from the waiver. If you own a franchise but you do not see your franchise on the directory, you may want to reach out to your franchisor to discuss becoming an SBA-affiliated franchisor so that you may benefit from the waiver.

Other businesses not covered by the waiver remain subject to the affiliation rules. These include businesses outside of the accommodation and foodservice industry owned by private equity firms, venture capital companies, and other investment companies with more than 500 employees after applying the affiliation rules. Businesses that do not qualify for the waiver to the affiliation rules under the CARES Act should determine if a waiver or exception exists under the SBA affiliation rules.

It is important that businesses review all applicable affiliation rules and exceptions before they apply for funding. The current 7(a) application requires that the applicant disclose all affiliates and certify the accuracy of the information provided. The penalty for knowingly making a false statement to obtain a guaranteed loan from the SBA may result in large fines and even jail time. While we have not yet seen the application for funding under the Payroll Protection Program, it may include a similar certification.

Our team of attorneys is here to help you analyze the affiliation rules and how they apply to your business. We can also help with other issues facing business concerns, such as reviewing existing debt documents to determine whether you are permitted to obtain additional loans. Lenders are expecting to see a high volume of applications with the funding of covered loans being said to start as early as Friday, April 3, 2020. Additional guidance on what is required to apply for the covered loans should come out this week as the SBA rolls out how the Payroll Protection Program will be implemented.

For more information on the Payroll Protection Program and financial assistance available to businesses under the CARES Act, please contact [Becky Moore](#) or any attorney in Frost Brown Todd's [Finance](#) Practice Group.

*To provide guidance and support to clients as this global public-health crisis unfolds, Frost Brown Todd has created a **Coronavirus Response Team**. Our attorneys are on hand to answer your questions and provide guidance on how to proactively prepare for and manage any coronavirus-related threats to your business operations and workforce.*

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[1] The 500-employee threshold includes all employees: full-time, part-time and any other status.

[2] The business concern must also be an operating business located in the United States.

[3] 13 CFR Section 121.201.

[4] 13 CFR 121.301(f).

[5] There are also certain exceptions to affiliation in 13 CFR 121.103(b).

[6] See <https://www.sba.gov/document/support-sba-franchise-directory> for a list of franchises that have a franchise identifier code.

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