



Preparing for an SBA PPP Audit: Eligibility and Loan Amount Compliance Issues

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UPDATE (5/19/20): This article has been updated to include the Interim Final Rule published on May 18, 2020, which requires PPP applicants to count all employees, including those who reside outside of the United States, for the CARES Act Size Test (as defined below).

This is part of our Preparing for an SBA PPP Audit Series, which is aimed at providing informed and real-time guidance on how to comply with the PPP and prepare for an audit by the SBA. It examines common questions from borrowers relating to the necessity certification, eligibility, calculation of the loan amount, use of the PPP loan proceeds and obtaining loan forgiveness. Each article will provide you with a checklist of what you should consider including in your loan file.

Additional articles:

[SBA Issues New Safe Harbor for the Necessity Certification for Paycheck Protection Program Loans – Updated 5-14-20](#)

[Preparing for an SBA PPP Audit: The Necessity Certification](#)

[ALERT – Paycheck Protection Program 2.0: New Rules and Additional Guidance as of April 26, 2020](#)

[Comparing Paycheck Protection Program and Emergency Economic Injury Disaster Loan Options for Small Businesses Under the CARES Act](#)

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

The Department of Justice has filed charges against three individuals alleging that they provided false information as part of the Paycheck Protection Program (PPP) loan application package. The individuals all claimed to have employees at various businesses when in fact there were allegedly no employees working for any of

the businesses.^[1] While so much of the press and recent guidance from the Small Business Administration (SBA) has centered around the “necessity certification,”^[2] it is important that borrowers go back and make sure that they are in compliance with all requirements of the PPP, including eligibility and the loan amount calculation. This article will address the issues we have seen regarding which employees should be counted in the eligibility size tests and what happens if the loan amount is higher than what a borrower needs to spend on payroll costs during the 8-week period. Although there are few certainties with the PPP, applicants can at least substantiate their processes for determining their eligibility and loan amount, thereby minimizing the risk that the SBA denies loan forgiveness or imposes any penalties for false certifications.

Determining Size for Purposes of Eligibility

Sec. 1102 of the CARES Act provides that to be eligible the applicant must either, be a “small business concern,” ^[3] which has to satisfy existing SBA size tests based on revenue or number of employees, or an otherwise eligible applicant,^[4] which has to satisfy an employee-based size standard set forth in the CARES Act. An applicant also must have been in operation on February 15, 2020 and had employees for whom it paid salaries and payroll taxes or must have paid independent contractors. Sole proprietors, independent contractors and self-employed individuals may also be themselves be eligible for PPP loans.

Three basic size tests for eligibility emerged for a PPP loan (the first two being referred to herein as the “Existing SBA Size Tests” and the third test being referred to herein as the “CARES Act Size Test”). An applicant must:

- Be a “small business concern” and satisfy the small business size standard for the industry in which the applicant is primarily engaged and, combined with its affiliates, satisfy the size standard designated for either the primary industry of the applicant alone or the primary industry of the applicant and its affiliates, whichever is higher;

- Be a “small business concern” and satisfy (including all affiliates) the SBA’s “alternative size standard”;^[5] or
- For all other applicants eligible under the CARES Act, as 501(c)(3) nonprofit organization, 501(c)(19) veteran organization, tribal business concerns, or other business concerns, employ, when combined with its affiliates, not more than the greater of (i) 500 employees whose principal place of residence is in the United States; or (ii) the maximum number of employees permitted by the applicable SBA’s size standard for the primary industry in which the applicant is primarily engaged.

Applicants must include the employees or revenue of their affiliates in the size calculations if the affiliation rules described in 13 C.F.R. §121.301 apply.^[6] The affiliation rules generally provide that “concerns and entities are affiliates of each other when one controls or has the power to control the other, or a third party or parties controls or has the power to control both.”^[7] An applicant may have affiliates that it owns or is owned by, or that it shares common management with, or with which it has a franchise relationship, among other factors.^[8] Even where no single factor constitutes affiliation, the SBA may still determine that an applicant has affiliates based upon the “totality of the circumstances.”^[9] Any applicant concerned about determining the status of its affiliation should seek the advice of counsel. Once an applicant has made this determination, it must consider the combined number of employees that it has, together with its affiliates.

Recently there have been questions regarding whether an applicant must count all employees of its domestic and foreign affiliates or just employees whose principal residence is in the United States, especially in light of the recent FAQ #44 issued by the SBA.

The SBA requires small business concerns to count every employee of the applicant and all domestic and foreign affiliates of the applicant, regardless of full-time or part-time status. The existing SBA regulations on 7(a) loans do not limit employees to only employees who reside in the United States. Until the SBA and Department of Treasury published the first Interim Final Rule on April 2, 2020, there were no residency-based qualifications when

counting employees under the CARES Act Size Test.

It was not until the first Interim Final Rule was published by the SBA that a residency qualifier was added to the CARES Act Size Test. Section 2(a) of the first Interim Final Rule provided “[y]ou are eligible for a PPP loan if you have 500 or fewer employees whose principal place of residence is in the United States...” FAQ #3, published on April 6, 2020, repeated this qualification and stated, “[i]n addition to small business concerns, a business is eligible for a PPP loan if the business has 500 or fewer employees whose principal place of residence is in the United States...” It goes on to say that PPP loans are also available for 501(c)(3) nonprofit organizations, 501(c)(19) veterans organizations, and Tribal business concerns that have 500 or fewer employees whose principal place of residence is in the United States. FAQ #33 provides existing guidance for how applicants and lenders can determine whether an individual employee’s principal place of residence is in the United States. Based on this guidance, many businesses deemed themselves eligible for the PPP because they did not have to count employees who resided outside of the United States.

On May 6, 2020, the SBA published FAQ #44, which stated that an applicant must count all of its employees and the employees of its U.S. and foreign affiliates, absent a waiver of or an exception to the affiliation rules. This FAQ has caused concern for many companies with foreign affiliates because the question does not limit employees to only those whose primary residence is in the United States. On May 18, 2020, the SBA released an [Interim Final Rule](#) concerning the Treatment of Entities with Foreign Affiliates under the PPP. According to the new rule and FAQ #44, all employees of affiliates are to be counted for purposes of determining if the SBA’s employee size standards are met for purposes of PPP eligibility. The principal place of residence of the employee is not relevant for purposes of this headcount. If an applicant, together with its domestic and foreign affiliates, does not meet the Existing SBA Size Tests or the CARES Act Size Test, it is not eligible for a PPP loan. Citing reasonable borrower confusion based on prior SBA guidance, this clarification will not be applied to borrowers who applied for their PPP loan prior to May 5, 2020 and did not include non-U.S. employees in their headcount determinations. The SBA will not

consider the eligibility certification to be inaccurate in this regard for those borrowers.

Aside from counting employees of all domestic and foreign affiliates, the SBA has confirmed that student workers should also be counted unless (i) the applicant is an institution of higher education,^[10] and (ii) the student worker's services are performed as part of a Federal Work-Study Program^[11] or a substantially similar program of a state or political subdivision.^[12]

There remains some question as to whether applicants should consider independent contractors as employees for purposes of determining PPP eligibility. The SBA does not allow applicants to include wages paid to independent contractors when determining the amount of the PPP loan. However, the CARES Act defines employees as "individuals employed on a full-time, part-time, or *other* basis (emphasis added).^[13] While the SBA has not clarified its interpretation of "other basis" as of May 15, 2020, if wages to independent contractors are not included when determining the maximum loan amount, we interpret this to mean that independent contractors should also not be included when counting employees.

After determining which employees need to be counted for one of the employee-based size standards, borrowers should use average employment over the previous 12 months, or from calendar year 2019, to determine their number of employees when applying an employee-based size standard. Alternatively, borrowers may elect to use SBA's usual calculation: the average number of employees per pay period in the 12 completed calendar months prior to the date of the loan application (or the average number of employees for each of the pay periods that the business has been operational, if it has not been operational for 12 months).^[14]

Determining the Amount of the PPP Loan

Once an applicant has determined it is eligible for a PPP loan, it must then calculate the maximum amount of the loan for which it is eligible. The amount of the loan is limited to the lesser of (i) \$10,000,000 or (ii) 2.5 times an applicant's eligible "payroll costs" plus the amount of any Economic Injury Disaster Loan (EIDL) originated on or after January 31, 2020 being refinanced with PPP

proceeds (less the amount of any advance received under an EIDL). In this calculation, an applicant must only consider its own payroll costs and not those of its affiliates, even though it had to consider its affiliates' employees when determining eligibility. The CARES Act defines "payroll costs" as:

- Salary, wage, commission, or similar compensation;
- Payment of cash tips or equivalent;
- Payment for vacation, and parental, family, medical, or sick leave;
- Allowance for dismissal or separation (e.g. severance pay);
- Health insurance premiums and other payments for provision of healthcare benefits;
- Retirement benefits; and
- State/local taxes on employee compensation.

The required exclusions include:

- Any compensation for each individual employee in excess of an annual salary of \$100,000 as prorated for the Covered Period (between February 15, 2020 and June 30, 2020);
- Federal taxes for payroll, railroad retirement, and income;
- Compensation of each employee with a principal residence outside United States;
- Qualified sick and family leave wages where credit is allowed under Families First Coronavirus Response Act.

Borrowers may calculate their aggregate payroll costs using data either from the previous 12 months or from calendar year 2019. For seasonal businesses, the borrower may elect to use the average monthly payroll for any of the following periods:

- the period beginning February 15, 2019 through June 30, 2019;
- the period beginning March 1, 2019 through June 30, 2019; or
- any consecutive 12-week period between May 1, 2019 through September 15, 2019.

An applicant that was not in business from February 15, 2019 to June 30, 2019 may use the average monthly payroll costs for the period January 1, 2020 through February 29, 2020.

Applicants then have 8 weeks from the date of the initial disbursement of the PPP loan (or the date of the first payroll after the initial disbursement) to spend the loan proceeds on eligible expenses.^[15] Provided the applicant satisfies the requirements described in the CARES Act, the SBA will forgive up to 100% of the loan amount.

Many borrowers applied for the maximum loan amount, which may be more than the amount the borrower can have forgiven during the 8-week covered period for permitted uses. Borrowers who have a reduced workforce when compared to the measuring period, due to COVID-19 or otherwise, are likely to have a loan amount greater than the amount that can be forgiven and greater than actual expenses for the permitted uses (even without forgiveness). Because of the economic uncertainty, many borrowers did not think about how much they needed during the 8-week period. In addition, at the opening of the first round of PPP funding, the limitation requiring 75% of the loan proceeds to be used on payroll costs had just come out. Most borrowers had already submitted their applications.

Under the CARES Act, borrowers are permitted to use PPP loan funds for payroll costs, interest on mortgage and other debt, rent, and utilities (provided the mortgage, other debt, rent, and utilities are in place or in service before February 15, 2020). It seems that borrowers may use PPP loan proceeds to pay eligible expenses that were incurred after February 15, 2020 but before the PPP loan proceeds were received. However, the amount of proceeds used in this fashion will not be forgiven. Proceeds that are used for permissible uses between February 15, 2020 and June 30, 2020 that are not forgiven will become a loan.

It is still unknown what will happen if borrowers use loan proceeds other than for the permitted uses identified by the CARES Act. Some are saying that any amount used for other purposes will become part of the loan amount (and not forgiven), while others are saying those amounts will have to be repaid immediately. The first [Interim Final Rule](#) states that “[i]f you use PPP funds for

unauthorized purposes, SBA will direct you to repay those amounts. If you knowingly use the funds for unauthorized purposes, you will be subject to additional liability such as charges for fraud.”^[16] If borrowers are not able to use the full amount of the loan on the permitted uses, with 75% of that amount being for payroll costs, borrowers should consider holding on to the excess funds until clarifying guidance is issued by the SBA. Further, there is a distinct possibility that the 75% requirement will be eliminated or significantly modified. The Office of Inspector General’s [report](#) on May 8th recommended that the 75% requirement be removed by the SBA. The money that is not used can always be repaid if necessary at the time the borrower seeks loan forgiveness.

We should note that the May 18 Interim Final Rule also expressly states that “[u]nder no circumstances may PPP funds be used to support non-U.S. workers or operations.” While the compensation of non-U.S. employees has always been excluded from being a permitted use through the definition of payroll costs under the PPP, and the intent of the CARES Act and the design of the PPP (including as referenced in the April 2 rule) is to keep workers paid and employed in the U.S., this is a very distinct statement that certain borrowers should keep in mind as they proceed with otherwise permitted uses of PPP funds.

We expect the SBA to issue additional guidance on loan forgiveness requirements and permissible uses.

While the recent focus has concentrated on the necessity certification, as described in our last [article](#) in the Preparing for an SBA PPP Audit Series, borrowers need also consider the certifications regarding eligibility and the loan amount when looking at other potential compliance issues with respect to the PPP. The SBA has not clarified exactly how it will address inaccuracies contained in an application with respect to an applicant’s eligibility under the size standards, or the loan amount. While we believe the risk of criminal liability is low for applicants exercising good faith, we advise all applicants to maintain detailed records and documentation supporting their loan amount calculation and the expenses satisfied with loan proceeds.

We recommend borrowers consider adding the following documents relating to eligibility and the loan amount to their loan files in case of an audit by the SBA:

- Organizational chart and documents showing at least all owners owning 20% or more of the borrower, directly or indirectly;
- Entity formation documents of the borrower, including evidence that the borrower was in business on February 15, 2020;
- Entity formation documents of all entity owners shown on the organizational chart (if applicable);
- Internal document with analysis of the affiliation rules as they apply to the borrower;
- Copies of all IRS Form W-2s issued to employees for 2019;
- Internal document with the facts used by the borrower to determine which employees resided primarily in the United States based on IRS regulations (26 CFR Section 1.121-1(b)(2));
- Calculation of size based on one of the three size standards, described above, and how the borrower reached that decision;
- Monthly payroll reports for 2019 and 2020 year to date (depending on the time periods used to determine average number of employees and average monthly payroll costs);
- Completed 2019 business tax return or 2019 profit and loss report and balance sheet;
- Filed 2018 business tax return;
- Evidence of funds received in the form of an EIDL since January 31, 2020;
- Evidence of payments for group health care benefits including premiums paid in 2019 and 2020 (year to date including the 8-week period after the loan is awarded); and
- Evidence of payment of any retirement benefits paid in 2019 and 2020 (year to date including the 8-week period after the loan is awarded).

We will be covering the permissible uses of the PPP loan proceeds and loan forgiveness issues in our next article in our Preparing for an SBA PPP Audit Series.

For more information, please contact [Becky Moore](#), [Shannon Kuhl](#), [Joe Brammer](#), or any attorney in Frost Brown Todd's [Financial Services](#) industry team.

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.

[1] See ["Two Charged in Rhode Island with Stimulus Fraud"](#), published on May 5, 2020, and ["Engineer Charged in Texas with COVID-Relief Fraud"](#) published on May 13, 2020.

[2] The applicant must certify in the PPP application that "[c]urrent economic uncertainty makes the loan request necessary to support its ongoing operations."

[3] Under the Small Business Act, a "small business concern" is an is (i) independently owned and operated, (ii) for-profit entity, (iii) that is not dominant in its field, (iv) having a place of business and operating primarily within the U.S. or making a significant contribution to its economy, and (v) satisfying the applicable revenue or employee-based size standard for the NAICS code describing its primary industry of operation.

[4] Including for-profit entities, 501(c)(3) nonprofit organizations, 501(c)(19) veterans organizations, as well as Tribal business concerns.

[5] An applicant must meet both tests in SBA's "alternative size standard" as of March 27, 2020: (1) maximum tangible net worth of the business is not more than \$15 million; and (2) the average net income after Federal income taxes (excluding any carry-over losses) of the business for the two full fiscal years before the date of the application is not more than \$5 million. The SBA has not defined tangible net worth. Commentators agree that it at least

means net worth less “goodwill.” A more conservative definition would be net worth less the value of all intangible assets such as patents, copyrights, and other intellectual property.

[6] The CARES Act provided that the affiliation rules in 13 C.F.R. §121.103 govern the eligibility determination for PPP applicants. However, the SBA determined that the rules described in 13 C.F.R. §121.301 were applicable in guidance issued on April 3, 2020. The differences between these statutes will be have little impact for most borrowers and this article assumes that those rules under 13 C.F.R §121.301 control. See AFFILIATION RULES APPLICABLE TO U.S. SMALL BUSINESS ADMINISTRATION PAYCHECK PROTECTION PROGRAM (<https://home.treasury.gov/system/files/136/Affiliation%20rules%20overview%20>, last accessed 5/11/20).

[7] 13 C.F.R. §121.301.

[8] See 13 C.F.R. §121.301(f)(1–6).

[9] 13 C.F.R. §121.301(f)(6).

[10] As defined in the Department of Education’s Federal Work–Study regulations, 34 C.F.R. §675.

[11] As defined in the Department of Education’s Federal Work–Study regulations, 34 C.F.R. §675.

[12] See [Interim Final Rule](#) issued on May 8, 2020.

[13] §1102 of the CARES Act modifying 15 U.S.C. § 636.

[14] FAQ #14 published on April 6, 2020.

[15] Consisting of payroll costs, utilities, and certain mortgage and rent expenses.

[16] Interim Final Rule 1, 13 CFR Part 120, RIN 3245–AH34 (April 2, 2020).

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