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SBA 7(a) Loans to Buy a Business: Rules That Shape a Deal

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What this article covers

Entrepreneurship through acquisition (ETA), buying an existing small business and running it, is often financed with an SBA 7(a) loan. The SBA's rulebook for those loans shapes price, structure and the seller's role more than most first-time buyers expect.

This article reads that rulebook. It describes Standard Operating Procedure (SOP) 50 10, version 8.1, which the SBA lists as effective October 1, 2026 (SBA, SOP 50 10 page). The change-of-ownership rules sit in Appendix 15 of that document (SOP 50 10 8.1, .docx). Guides written under versions 7.1 or 8 differ in places. This describes published rules, not lending, legal or tax advice; lenders often apply stricter credit policies on top.

For PE deal teams the relevance is indirect: SBA-financed buyers can be counterparties in smaller sale processes, and they bid under constraints that institutional sponsors do not face.

What 7(a) can fund in a change of ownership

The SBA's program page lists "Changes of ownership (complete or partial)" among permitted uses of 7(a) proceeds and states that "the maximum loan amount for a 7(a) loan is $5 million" (SBA, 7(a) loans). The regulation behind this, 13 CFR 120.202, allows a borrower to use proceeds to purchase a portion of or the entirety of an owner's interest in a business, or a portion of or the entirety of the business itself (13 CFR 120.202).

Appendix 15 adds the working definitions:

- A change of ownership can be a stock purchase (including a stock redemption) or an asset purchase. An asset purchase counts as a change of ownership when the buyer acquires "all or substantially all of the assets" and continues the seller's operations; without that continuity, the lender may evaluate the deal as a start-up (SOP 50 10 8.1, App. 15).

- "A 7(a) loan cannot be made solely to an individual." The small business must be the borrower or a co-borrower.
- The "Business Purchase Price" excludes owner-occupied commercial real estate in the deal. Many thresholds below key off this number, measured before buyer equity, seller debt or any other financing.
- Intangibles (goodwill, customer lists, IP, non-competes) can be financed if the financial due diligence requirements are met.
- Change-of-ownership loans may not amortize over more than 10 years, except for real estate portions and certain special purpose properties, and may not have a balloon.

The four transaction categories

Appendix 15 sorts every deal into one of four categories, and "Initial Acquisition is the default category." To qualify for any other category, the lender must document why in its credit memorandum.

Category	Plain-language description (SOP 8.1)	Seller may stay as owner/employee?
Initial Acquisition	Results in a new majority or largest individual owner who was not previously an owner, or who has been employed by the business for fewer than 24 months	No; consultant only, up to 24 months in aggregate
Business Expansion	An existing small business, operating at least two full fiscal years under current ownership, buys 100% of another business in the same four-digit NAICS Industry Group	No; consultant only, up to 24 months in aggregate
Owner Buyout (Existing or Partial Change)	Changes the ownership of the applicant itself, with no acquisition of another entity; at least one original owner remains and guarantees	Yes
ESOP & Cooperative	An ESOP, equivalent trust or cooperative buys a controlling interest (51% or more)	Yes, with conditions

Two details matter for searchers and for anyone bringing in a partner:

1. **The 24-month employment line.** In Owner Buyouts, individuals who have not been employed by the business for at least 24 months "may only acquire less than 50% of the total equity and may not become the largest direct or indirect shareholder." Indirect holdings through holding companies, trusts or partnerships are aggregated. If the deal breaks that line, the lender must apply Initial Acquisition credit standards (minimum DSC, minimum equity injection and QoE), although the seller keeps the right to remain as an owner and employee.
2. **Multi-step partial changes are ineligible.** The SOP excludes structures where existing owners and a new owner form a new entity that becomes the 100% owner of the operating company. That is close to the classic holdco-with-rollover structure used in sponsor deals, so it cannot simply be copied into a 7(a) deal.

Equity injection: how much and from where

The minimum

SOP 8.1 sets the minimum equity injection at 10% for every change-of-ownership category (SOP 50 10 8.1, App. 15):

- **Initial Acquisition: 10%.** "For Initial Acquisitions, the required equity injection cannot be reduced or eliminated."
- **Business Expansion, Owner Buyout, ESOP & Cooperative: 10%.** For Business Expansions and Owner Buyouts, the lender may reduce or eliminate the requirement if the borrower has sufficient liquidity and working capital, and only if the applicant's balance sheet does not show a negative net worth at the last fiscal year-end. Loans to an ESOP buying a controlling interest are not subject to the equity injection requirement.

The base is **total project cost** (all costs required to become operational, regardless of the source of funds, except lines of credit and 504 loans). For Owner Buyouts, the base is the purchase price in the purchase agreement. Buyers who compute 10% of the purchase price alone in an Initial Acquisition will under-plan their cash.

The sources

The SOP splits equity into two buckets.

Unlimited equity sources include cash that is not borrowed (on the business balance sheet or from other sources such as a gift); cash from a personal loan to a guarantor if repayment can be shown to come from a source other than the business's cash flow (the owner's salary from the business does not qualify); grants with no repayment or clawback provisions; and verified eligible prepaid expenses. Education, advisory services and fees paid to an Agent are not eligible prepaid expenses.

Limited equity sources "whether individually or in the aggregate, may provide no more than half of the required Equity Injection." The listed categories are:

- **Standby debt**, defined as debt "on full standby (no payments of principal or interest for the term of the 7(a) loan)". It may accrue interest, to be amortized after the 7(a) loan is repaid; the standby creditor must subordinate its lien rights and take no action without the lender's consent; and "the provider of standby debt may not take an equity investment in the business."
- **Seller debt** that is subordinated to the lender and on full standby.
- **Non-controlling minority equity investments**, where the investor holds less than 20% of the equity, exerts no control, and has no agreement to be repaid or receive distributions to recover the investment before the SBA guaranty is released.

Additional limited-source funds can be used when the sale price exceeds the value supported by the business valuation and QoE, but those additional funds must be on full standby.

Seller notes under SBA rules

SOP 8.1 treats seller financing in three ways (SOP 50 10 8.1, App. 15):

Seller note structure	How the SOP treats it
Subordinated, full standby for the life of the 7(a) loan	May count as equity (limited source, capped with other limited sources at half the injection)
Subordinated but paying principal or interest	Debt. "The total debt eligible to support a change of ownership transaction (including seller debt that is not on full standby) is limited to the business valuation amount" and must be covered by DSC
Any seller-financed note, later	Eligible for refinancing after it "has been in place and current for 36 months", subject to the 10 percent payment-improvement test

Two adjacent rules close obvious workarounds:

- **"Seller earnouts are prohibited."** Buyer rebates based on business performance are allowed, and any rebate received must be applied to the 7(a) loan's principal. Working-capital true-ups in the purchase agreement are not rebates.
- If interest-only debt that is not on full standby supports the purchase, the lender must apply an amortization of no more than 10 years when testing coverage.

In practice, an SBA seller's deferred consideration is either patient (standby) or modest (amortizing, but counted against valuation and coverage); an earn-out is unavailable.

Valuation, quality of earnings and cash-flow tests

Independent business valuation

The lender must obtain a business valuation from a "Qualified Source": an individual who regularly receives compensation for valuations, is independent of the loan production function, and holds one of the listed credentials (ASA, CBA, ABV, CVA or BCA). The valuation must be requested by and prepared for the lender; "the Lender may not use a business valuation prepared for the Applicant or the seller." If the Business Purchase Price is $350,000 or less, the lender may perform its own valuation unless there is a close relationship between buyer and seller (SOP 50 10 8.1, App. 15).

The valuation must support the Business Purchase Price "regardless of how the debt is structured. If the amount paid for the business exceeds the business valuation, the difference must be made up by equity." The lender must also verify the financial data the appraiser relied on against the seller's IRS transcripts.

Quality of earnings at $3 million

For Initial Acquisitions and Business Expansions with a Purchase Price "equal to or greater than $3 million," the lender must also obtain a quality of earnings (QoE) report. Owner Buyouts and ESOP/cooperative deals are exempt because existing owners retain operating knowledge. The SOP sets minimum content:

- Performed by an independent, experienced financial professional, for the benefit of the lender; "the report must not be prepared by or for the seller." A buyer's own QoE can be used only after review by one of the lender's approved vendors.
- Reconciles accountant-prepared statements, tax returns, internal statements and IRS transcript data into normalized, arm's-length earnings.
- Includes a **cash proof** (bank statements reconciled to the income statement and tax return) on a trailing 12-month basis and for the last two fiscal years.
- Documents all add-backs and adjustments, including non-recurring items, above- or below-market owner compensation, related-party transactions, deferred maintenance and cash-versus-accrual differences, and assesses customer concentration and revenue sustainability.

The lender must then use the QoE earnings in its coverage calculation. If coverage does not support the valuation and debt, the loan amount is reduced.

Debt service coverage

Historical DSC is defined as EBITDA divided by combined post-transaction debt service, measured on the last fiscal year or the average of the last two. The minimums by category:

Category	Minimum DSC
Initial Acquisition	1.25:1
Business Expansion	1.15:1
Owner Buyout	1.25:1
ESOP and Cooperative	1.25:1

Lenders may adjust cash flow for unfunded capex, non-recurring income, distributions, S-corp tax distributions, seller discretionary expenses and ownership compensation, with written justification for each. Adjustments to ownership compensation must also be supported by a global cash flow analysis meeting "the 1:1 DSC on a global basis," and the buyer's compensation must cover their own obligations and living expenses. Post-closing projections must be evaluated but "may not" be relied on to meet the DSC requirement (special purpose properties excepted).

What happens to the seller

"Except as provided below, the seller in a Business Expansion or Initial Acquisition change of ownership transaction may not remain as an officer, director, stockholder, or employee of the business." A transition is allowed through a consulting contract "for a period not to exceed 24 months (in aggregate, including any extensions)" (SOP 50 10 8.1, App. 15).

Sellers can remain owners or employees in an Owner Buyout (Partial Change) or when an ESOP or cooperative buys a controlling interest. In a partial change, a selling owner who receives loan proceeds and keeps less than 20% must provide a full guaranty for the full loan amount under 13 CFR 120.160(a).

Elsewhere in the SOP, any individual or entity owning 20% or more of the applicant must provide an unlimited full guaranty, and a six-month lookback applies to owners who reduce their stake before applying (SOP 50 10 8.1, Section A, Ch. 5).

For a seller comparing offers, this is the sharpest difference from a sponsor deal: in an SBA Initial Acquisition there is no rollover equity and no permanent seat, only standby or amortizing seller paper and a capped consulting period.

Eligibility: size, affiliation, citizenship and why sponsor-backed buyers rarely fit

The 7(a) program page lists the baseline: the business must operate for profit, be located in the U.S., "be small under SBA size requirements," not be an ineligible type, be unable to obtain the desired credit on reasonable terms from non-government sources, and be creditworthy (SBA, 7(a) loans). Three rules tend to rule out institutionally backed buyers:

1. **Size is measured with affiliates.** Under 13 CFR 121.103, concerns are affiliates "when one controls or has the power to control the other," and SBA "counts the receipts, employees, or other measure of size of the concern whose size is at issue and all of its domestic and foreign affiliates." A person that owns or controls "50 percent or more of a concern's voting stock, or a block of voting stock which is large compared to other outstanding blocks" controls the concern (13 CFR 121.103). A buyer controlled by a fund may therefore be sized together with entities under the same control. The specific size thresholds by NAICS code, and how they differ from a lower-middle-market mandate, are covered in SBA size standards vs the lower middle market.
2. **Citizenship of all owners.** SOP 8.1 limits financing to applicants whose "100% direct and/or indirect owners and SBA-required guarantors" are U.S. citizens or U.S. nationals with their principal residence in the U.S., and whose entity owners are organized in the U.S. (SOP 50 10 8.1, Section A, Ch. 1). Pooled vehicles with many indirect owners can find this difficult to document.
3. **Distributions.** When equity investments meet the injection, distributions to those investors beyond tax distributions are prohibited until the 7(a) loan is paid off.

These are general rule checks, not conclusions about any particular buyer. Eligibility is determined by the lender and SBA on the facts.

Illustrative example (fictional): a $2 million Initial Acquisition

Harbor Lane Services is a fictional route-based services business. A first-time buyer agrees a $2,000,000 purchase price (no real estate). All figures are invented; the interest rate is an assumption, not an SBA figure.

Line	Amount	Rule applied
Purchase price	$2,000,000	Business Purchase Price, below $3M, so QoE not required by the SOP (lender may still require one)
Closing costs and working capital	$200,000	Part of total project cost

Line	Amount	Rule applied
Total project cost	$2,200,000	Base for the injection in an Initial Acquisition
Required equity injection (10%)	$220,000	Cannot be reduced in an Initial Acquisition
Buyer's own unborrowed cash	$150,000	Unlimited source
Seller note, subordinated, full standby	$70,000	Limited source; cap is half of $220,000 = $110,000
7(a) loan	$1,980,000	Under the $5M program maximum
Annual debt service (assumed 9%, 10-year amortization)	about $301,000	Change-of-ownership amortization capped at 10 years
Seller's reported EBITDA	$520,000	
Lender's adjustment: replace owner's below-market salary with a market wage	minus $70,000	Ownership-compensation adjustment, written justification required
Adjusted EBITDA	$450,000	
DSC	about 1.50x	Above the 1.25:1 minimum; breakeven at about $376,000

What the example shows: the seller gets $1.93 million in cash at close (loan plus buyer cash, less costs, before taxes and fees), carries $70,000 that cannot be paid until the 7(a) loan is gone, cannot stay as an employee beyond a 24-month consulting arrangement, and cannot receive an earn-out. A sponsor bidding $2.0 million with an earn-out and rollover is offering a structurally different deal, even at the same headline price.

Implications for origination teams

- **Price is not the only comparison.** Against a sponsor, an SBA buyer differs on certainty (lender, valuation and QoE gates), timing, seller role and deferred consideration.
- **Owner pay matters twice.** One owner-compensation adjustment moves both the asking multiple and the lender's DSC; record which figure each party used.
- **Record the version.** When a note says a deal "is SBA-financeable," record the SOP version and paragraph relied on; these rules change between versions.

Checklist: questions to ask before relying on 7(a) in a deal

- Which category will the lender assign (Initial Acquisition by default)? What documentation supports another category?
- What is total project cost, and is 10% of it available from unlimited sources, with limited sources at or under half?

- Is any seller note on full standby, and does the seller understand no payments occur during the 7(a) term?
- Does the purchase price fit within an independent valuation prepared for the lender?
- Is the Business Purchase Price at or above $3 million, triggering a lender QoE with a cash proof?
- Do the adjusted earnings cover debt service at the category's minimum DSC, with every owner-compensation adjustment justified in writing?
- Will the seller need to stay beyond 24 months, hold equity or receive an earn-out? If yes, a 7(a) Initial Acquisition is the wrong structure.
- Are all direct and indirect owners able to meet the citizenship, guaranty and affiliation rules?

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