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Small-Business Set-Asides

On May 31, the Small Business Administration published significant rule changes that should make it easier for small-business concerns to qualify for set-aside contracts. Regarding the limitation on subcontracting, the new rules say the relevant inquiry is no longer what percentage of work the prime contractor is performing. Instead, the question is what percentage of payments by the government under the prime contract are going to all ''similarly situated'' small businesses combined, including the prime and first-tier subcontractors.

BNA INSIGHTS: Rule Changes Create New Opportunities for Small Businesses

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In its quest to ensure that the benefits of small-business set-aside contracts really go to small-business concerns, the Small Business Administration (SBA) long ago created a rule that has sometimes acted as an obstacle for small businesses.

This rule requires the prime contractor to perform at least 50 percent of the work under a set-aside contract. (By the way, the standard is not 51 percent, as we often hear people say; it is ''at least 50 percent.'' *See* FAR 52.219-14.) This ''limitation on subcontracting,'' as it is known, meant that a small business that did not propose to perform 50 percent of the work itself could not get a small-business set-aside contract.

But no longer! On May 31, the SBA published significant rule changes that should make it easier for small-

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business concerns to qualify for set-aside contracts. (These changes are at 81 Federal Register 34,243.)

Regarding the limitation on subcontracting, the new rules say the relevant inquiry is no longer what percentage of work the prime contractor is performing. Instead, the question is what percentage of payments by the government under the prime contract are going to all ''similarly situated'' small businesses combined, including the prime and first-tier subcontractors.

In this context, ''similarly situated'' means a small-business subcontractor that is a participant in the same small-business program in which the prime contractor is a certified participant and which qualifies the prime contractor to receive the prime contract award. In effect, work performed by a similarly situated entity as a first-tier subcontractor will count as work of the small-business prime contractor.

For example, if a services or supply contract is set aside for small businesses, the SBA will look at whether 50 percent of the amount paid by the government under the prime contract ultimately goes to small businesses, including the prime contractor and any first-tier subcontractors that also are small businesses.

If a contract is set aside for service-disabled, veteran-owned (SDVO) small businesses, the SBA will look at whether 50 percent of the amount paid by the government ultimately goes to SDVO small businesses, including the prime contractor and any first-tier subcontractors that also are SDVO small businesses.

Work that is not performed by the employees of the prime contractor or employees of first-tier similarly situated subcontractors will count as subcontracts performed by non-similarly situated concerns. Thus, payments that ultimately go to large businesses, non-similarly situated small businesses, or to second-tier and lower subcontractors of any size will not count toward the prime's 50 percent (*see* new 13 C.F.R. § 125.6).

Under the new rules, limitations on subcontracting apply only to the portion of the requirement identified by the contracting officer as the primary purpose of the contract. For example, if the contract has a North American Industry Classification System (NAICS) code for supplies, but it includes incidental services, the cost of services won't be considered in the 50 percent calculation.

Conversely, if the contract has a NAICS code for services, but it includes incidental supplies, the cost of supplies won't be considered in the 50 percent calculation. Therefore, the prime contractor can subcontract 100 percent of the supply components to any size business.

These changes may allow a small business to create a team to win a set-aside contract it could not have won on its own. For example, take a competitive 8(a) contract for janitorial services valued at $10 million. A small startup concern might be unable to perform this contract alone. Now, the prime contractor can subcontract $8 million (or more) of the janitorial services, as long as the subcontractor is another 8(a)-certified firm (*see* new 13 C.F.R. § 125.6(c)). Moreover, any amount spent on cleaning supplies, paper towels for the restrooms, and so on, likely will not count in the calculation.

Note that the ''similarly situated'' subcontractor need not be small under the same NAICS code that applies to the prime contract. Instead, the prime contractor should select the NAICS code most appropriate for the *subcontract* and should measure the subcontractor size against that code.

SBA says these changes became effective June 30. However, if an existing contract contains the prior version of the ''Limitations on Subcontracting'' clause at FAR 52.219-14, these regulatory changes presumably will have no impact.

The changes described above are not the only goodies for small businesses in the SBA's revised regulations. Another change is that the definition of ''affiliate'' in 13 C.F.R. § 121.103(h) has been modified so that no affiliation will be found between a prime contractor and its ostensible subcontractor if the subcontractor is a similarly situated small business.

In most cases to date, the ostensible subcontractor has been a large business. Nevertheless, the same concern could exist where a small prime was unduly reliant on a *small* subcontractor if their combined sizes exceeded the applicable size standard. That no longer will be a possibility. Also, the definition of affiliate in 13 C.F.R. § 121.103(b) has been changed to make it easier for two small businesses to form a joint venture.

The revised regulations contain some potential disappointments for small-business concerns. For example, under the revised definition of affiliation, there is a rebuttable presumption that two concerns have an identity of interest based upon economic dependence (and therefore are affiliated) if one concern derived 70 percent or more of its receipts from the other concern over the previous three fiscal years.

If a small business gets 70 percent of its revenues by subcontracting over and over with the same business, it may be found to be affiliated with that large business when the small business goes after a set-aside contract. This presumption may be rebutted by a showing that the concern at issue is not solely dependent on that other concern — for instance, where the concern at issue has been in business for only a short amount of time and has only been able to secure a limited number of contracts (*see* new 13 C.F.R. § 121.103(f)(2).

Knowing the small-business rules inside and out can help a small business thrive. On the other hand, failing to know and follow the rules can lead to serious penalties, including debarment. The choice should be an obvious one.

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