On May 31, 2016, the Small Business Administration **published** new rules that are sure to impact small businesses. The new rules are Final Rules—meaning the public comment period is over and now it is time to comply. They are effective on June 30, 2016.

But before we get into the meat of the new rules, let's pause for a moment and note that FAR is not—nor has it ever been—the sole regulatory publication that provides requirements and guidance for small businesses. Too many people look at FAR Part 19 ("Small Business Programs") and think that's all there is. Nope.

Sure, FAR Part 19 contains important stuff, such as size standards and industry NAICS codes, small business set-asides, small business subcontracting plans, and important contract clauses (*e.g.*, 52.219-14 "Limitations on Subcontracting). Those topics are important and they need to be read and understood. But they are not the be-all-and-end-all of the story. In addition to the FAR, people who are concerned with small business issues and compliance with SBA requirements need to also read and understand Title 13 of the Code of Federal Regulations—especially 13 CFR § 121, § 124, § 125, § 126, and § 127. That's where the SBA Regulations are hidden. If you just read the FAR and skip the SBA Regulations, you are missing some really important stuff that impacts compliance.

The rule changes we are about to discuss impact the SBA Regulations in CFR Title 13. It will take time for the FAR Councils to adjust the FAR to match the new SBA rules—and so you need to focus on the SBA Regulations and (to a large extent) ignore FAR Part 19 for a while.

So what are these huge SBA rule changes?

Limitations on Subcontracting

The FAR contract clause 52.219-14 establishes a minimum amount of work that must be performed by the "prime" small business receiving a small business set-aside contract award. The requirement is intended to prevent a small business from being used as a "front" for a large business. Thus, the clause requires that at least 50 percent of the contract work must be performed by the "prime" small business that received the contract. How that 50 percent

number is calculated depends on what is being acquired (services, supplies, or construction).

The new SBA rules clarify that the 50 percent value can include "similarly situated entity contractors." The rule-makers stated—

Specifically, the NDAA [National Defense Authorization Act of 2013, a public law that required SBA to make these rule changes] deems work done by similarly situated entities not to be subcontracted work for purposes of complying with the limitations on subcontracting requirement. Thus, work done by a similarly situated entity is counted in determining whether the applicable limitation on subcontracting is met. When a contract is awarded pursuant to a small business set-aside or socioeconomic program set-aside or sole source authority, a similarly situated entity subcontractor is a small business concern subcontractor that is a participant of the same SBA program that qualified the prime contractor as an eligible offeror and awardee of the contract.

To implement the required changes, the SBA modified § 125.6 to explain "how to apply the limitations on subcontracting requirements to small business set-aside contracts. Instead of providing different methods of determining compliance based on the type of small business set-aside program at issue and the type of good or service sought."

The new rules also specify how a Contracting Officer will determine which NAICS code applies to a procurement (and therefore which approach to the limitations on subcontracting calculation will be used. The appropriate NAICS code is based on the preponderance of what is being ordered, and the calculation applies only to that item. The rule-makers explained that—

The CO must first determine which category, services or supplies, has the greatest percentage of the contract value, and then assign the appropriate NAICS code. The corresponding limitations on subcontracting will apply to the contract, depending on whether the CO has selected a supply NAICS code or a services NAICS code. Thus, the statutory authority authorizes that the limitations on subcontracting apply only to that portion of the requirement identified as the primary purpose of the contract. … For a contract principally for services, but which also requires supplies, this means that the prime contractor or its similarly situated subcontractors cannot subcontract more than 50 percent of the services to other than small concerns. However, the prime contractor can subcontract all of the supply components to any size business.

Who is a Subcontractor?

Many small businesses use “1099 employees” (who are independent contractors) to support their contract performance requirements. There has long been controversy as to whether those independent contractors are subcontractors or subconsultants, or something else. (You *really* don’t want them to be employees unless you are making the proper payroll withholdings and making the proper payments to the IRS and other government agencies. For the record, we’ll note that the IRS says that if you control what the independent contractor does and how that person does it, then that person is in fact an employee.)

The new SBA rules clarify that “performance by an independent contractor is considered a subcontract.” The rule-makers attempt to put a positive spin on this clarification by noting that, if the independent contractor is a similarly situated entity, then the contractor’s efforts can be excluded from the limitations on subcontracting calculation. But we think the real story here is that if your independent contractors are not similarly situated entities (or cannot prove they are through the required certifications), then they *will* count as subcontracted dollars in the calculation. We strongly suspect that new approach is going to significantly impact many small business government contractors.

As a result of these rule changes, each small business that relies on 1099 independent contractors must reevaluate its approach. For some, it will mean converting individuals to employee status and making the required payroll-related payments (and perhaps extending other benefits). For others, it will require them to push their independent contractors to obtain the required certifications so as to prove that they are “similarly situated” as the small business prime contractor. In either case, a lot of work needs to be done—and done very soon. The rule-makers noted that large fines can be imposed for violations in this area.

Affiliation and Joint Ventures

Some changes were made to the affiliation rules, focusing on seemingly independent businesses owned by members of the same family. If that situation applies to you, we suggest you review the changes to the rules. In addition, the rules on joint ventures were changed “to broaden the exclusion from affiliation for small business size status to allow two or more small businesses to joint venture for any procurement without being affiliated with regard to the

performance of that procurement requirement." The final rules permits "a joint venture of two or more business concerns [to] submit an offer as a small business for a Federal procurement, subcontract or sale so long as each concern is small under the size standard corresponding to the NAICS code assigned to the contract."

Other Items

The rules on calculating annual receipts (for purposes of calculating business size under a NAICS code) were clarified to include all income (except income items already listed as exclusions)—including passive income. This may impact some small businesses if they were mistakenly excluding passive income from their annual receipts calculations.

The new rules clarify when a business size recertification is required following a merge or acquisition of a small business. They now state that "if the merger or acquisition occurs after offer but prior to award, the offeror must recertify its size to the contracting officer prior to award."

For those small businesses that participate (or that want to participate) in the Small Business Innovative Research (SBIR) or Small Business Technology Transfer (SBTT) programs, the rules clarified the size status of entities that are owned (or partially owned) by venture capital firms. The new rules state that—

… a single venture capital operating company (VCOC), hedge fund, or private equity firm may own more than 50% of an SBIR awardee if that single VCOC, hedge fund, or private equity firm qualifies as a small business concern which is more than 50% directly owned and controlled by individuals who are citizens or permanent resident aliens of the United States.

Conclusion

In summary, this is a significant rule-making effort with potential dramatic impacts to existing small businesses that are government contractors. We have only skimmed the surface in this article. If you want to learn more about this set of rule changes, we suggest you follow the link

and read the (very long) Federal Register publication for yourself. Or, better yet, we suggest you contact an attorney with experience in this area and obtain advice on how best to comply. As we noted above, you don't have much time and the potential downside of non-compliance could result in significant financial (and other) impacts to your business.