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SBA Final Rule Adopts Changes to Subcontracting Limitations and Other Regulations

By Joseph P. Hornyak and Robert K. Tompkins*

The U.S. Small Business Administration has issued a long-awaited final rule to implement certain small business-related provisions of the National Defense Authorization Act of 2013, including key changes in the Limitations on Subcontracting regulation. The authors of this article discuss the final rule.

The U.S. Small Business Administration ("SBA") on May 31, 2016, issued a long-awaited final rule[1] to implement certain small business-related provisions of the National Defense Authorization Act of 2013 ("NDAA"), including key changes in the Limitations on Subcontracting regulation.

In many instances, the final rule adopts with little or no change to the provisions of the proposed rule issued on December 29, 2014. However, in response to public comments on the proposed rule, SBA made important changes, including changes regarding subcontractors that qualify as "similarly situated" for purposes of the limitations on subcontracting, as well as how contracts for both services and supplies—described as "mixed" contracts—are treated for such purposes.

In addition to the limitations on subcontracting provisions, the final rule addresses numerous other SBA programs and requirements, including:

- the HUBZone program;
- subcontracting plans;
- the identity of interest affiliation rule;
- joint ventures;
- the calculation of annual receipts;
- recertification following a merger or acquisition;

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[1] https://www.federalregister.gov/articles/2016/05/31/2016-12494/small-business-government-contracting-and-national-defense-authorization-act-of-2013-amendments.

- the Small Business Innovation Research ("SBIR")/Small Business Technology Transfer ("STTR") programs;
- size protests and North American Industry Classification System ("NAICS") appeals;
- application of the non-manufacturer rule to software procurements;
- "adverse impact" analyses on construction contracts; and
- the Certificate of Competency ("COC") program.

LIMITATIONS ON SUBCONTRACTING

Section 1651 of the NDAA changed the formula for calculating the limitations on subcontracting under all types of small business set-aside contracts, principally to convert the analysis from one based on costs to one based on contract value. Previously, SBA regulations and the implementing FAR clause, entitled "Limitations on Subcontracting,"[2] required a small business prime contractor to perform with its own personnel a certain percentage of the cost of total direct labor on the contract, depending on whether the contract is primarily for services, supply, construction or specialty trade construction. As revised by Section 1651 and now adopted in the May 31 final rule, compliance will be determined by a percentage cap on the total amount of the prime contract that may be paid to subcontractors. In many respects, this should simplify the application of the requirement.

While the final rule alters the approach to making the calculation, the basic percentage limits remain essentially unchanged. For service and supply contracts, small business prime contractors must agree that no more than 50 percent of the total amount paid under the prime contract will be paid to subcontractors. For general construction contracts, the percentage is 85 percent, and for specialty trade construction, the percentage is 75 percent. In all such contracts, amounts paid to "similarly situated" entities are not considered "subcontracted" and thus excluded from the limitation.

SIMILARLY SITUATED SUBCONTRACTORS

The primary differences between the May 31 final rule and the December 29, 2014, proposed rule relate to "similarly situated" subcontractors. Consistent with the underlying statute, the proposed rule, and now the final rule, make clear that a small business prime contractor need not include the amounts subcontracted to a "similarly situated" subcontractor—i.e., another business

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[2] 52.219-14, entitled "Limitations on Subcontracting."

concern that falls into the same size or socioeconomic category for purposes of set-aside contracts—in determining the subcontracted percentage allowed. Put another way, work subcontracted to similarly situated subcontractors will count as work done by the prime contractor for Limitation on Subcontracting purposes. The exception for similarly situated subcontractors applies to all four types of contracts described in FAR 52.219-14 (services, supplies, construction, and specialty trade). The exception will also apply to any analysis under the ostensible subcontractor affiliation rule.[3]

The final rule, however, removed the phrase "at any tier" from descriptions of a similarly situated subcontractor in the proposed rule, so that only first-tier subcontractors will count as similarly situated.[4] Thus, any work that a similarly situated subcontractor subcontracts to another entity, large or small, will be counted as a subcontract to a non-similarly situated entity (i.e., treated as if it were subcontracted to a large business). Put simply, second-tier subcontracts will not be treated as similarly situated, even if the first-tier subcontractor is.

Also, in response to public comments, the final rule makes clear that individuals classified as "independent contractors" by the Internal Revenue Service ("IRS"), also known as "1099" personnel, will be considered subcontractors and may count toward meeting the applicable limitation on subcontracting when the independent contractor qualifies as a similarly situated entity.[5] Presumably, this means, for example, that an independent contractor working under a service-disabled, veteran-owned small business set-aside prime contract would count as "similarly situated" only if the independent contractor is also a service-disabled veteran.

The final rule also provides that an entity may qualify as a similarly situated entity if it is small under the size standard corresponding to the NAICS code that the prime contractor assigns to the subcontract.[6] This represents a change from the proposed rule, which would have applied the NAICS applicable to the prime contract to determine whether the subcontractor is similarly situated.

In response to public comments, the final rule removed the requirements in the proposed rule that the prime contractor enter into a written agreement with and report to the contracting officer on compliance with respect to similarly situated entities. This removes some of the administrative burden that the proposed rule would have applied to prime contractors seeking to take

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[3] New 13 C.F.R. 125.6(c).

[4] New 13 C.F.R. 125.6(a)(i), (ii).

[5] New 13 C.F.R. 125.6(e)(3).

[6] New 13 C.F.R. 125.1.

advantage of the exception for similarly situated subcontractors.

MIXED CONTRACTS/COST OF MATERIALS

The final rule introduces the term "mixed contract" to describe a contract that combines both services and supplies. For such a contract, the contracting officer must select the "single NAICS code which best describes the principal purpose of the product or service being acquired."[7] The code selected is determinative as to which limitation on subcontracting—services or supplies—is applicable.[8]

The final rule emphasizes that the subcontracting limitation applies only to the portion of the award amount determined to represent the principal purpose. The rule provides the following example of a "mixed contract" that is predominantly for services:

> A procuring agency is acquiring both services and supplies through a small business set-aside. The total value of the requirement is $3,000,000, with the services portion comprising $2,500,000, and the supply portion comprising $500,000. The contracting officer appropriately assigns a services NAICS code to the requirement. Thus, because the supply portion of the contract is excluded from consideration, the relevant amount for purposes of calculating the performance of work requirement is $2,500,000 and the prime and/or similarly situated entities must perform at least $1,250,000 and the prime contractor may not subcontract more than $1,250,000 to non-similarly situated entities.[9]

As this example illustrates, in a "mixed contract" that is assigned a services NAICS code, "the prime contractor can subcontract all of the supplies components to any size business."

The final rule also clarifies that the "cost of materials" is excluded from the subcontracting limitations in prime contracts for supplies, construction or specialty trade. In other words, the cost of purchased items such as commercial-off-the-shelf items, raw materials or special test equipment or tooling are not considered "subcontracted" for purposes of the limitation.[10] Several commenters urged SBA to extend this exclusion to services contracts. SBA declined to do

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[7] 13 C.F.R. 121.402.

[8] New 13 C.F.R. 125.6(b).

[9] New 13 C.F.R. 125.6(b).

[10] New 13 C.F.R. 125.6(a)(2).

so expressly, but noted that the cost of materials would be excluded from consideration in any mixed contract that is assigned a services NAICS code, as illustrated in the example above. As a practical matter, therefore, the "cost of materials" would not be considered subcontracted in a contract for services.

CONTRACTS OF LESS THAN $150,000 ARE EXEMPT

The final rule adopted SBA's proposed change to exempt contracts between $3,500 and $150,000 from the Limitation on Subcontracting requirements.

ADDITIONAL PROVISIONS

Below are some of the more notable provisions in the final rule:

Affiliation

The proposed rule created some bright-line tests for affiliation based upon identity of interest, but they are rebuttable presumptions. As before, affiliation would be presumed between firms owned and controlled by married couples, parties to a civil union, parents and children, and siblings.

In addition, SBA is creating a bright-line provision in its regulations that affiliation would also now be presumed upon economic dependence if the qualifying small business concern derived 70 percent or more of its receipts from another concern in the previously completed fiscal year. This codifies the law established through a series of cases issued by SBA's Office of Hearings and Appeals. A concern can rebut this presumption by showing it is not solely dependent on the other firm, such as when the concern is new and has only been in business a short amount of time and has secured a limited number of contracts.

Notably, the final rule exempts transactions between businesses owned by Alaska Native Corporations ("ANC"), Tribes or Native Hawaiian Organizations ("NHO") and sister companies from this presumption of affiliation.

Joint Ventures

The proposed rule removed the contract size requirement from the exclusion from affiliation for small businesses seeking to perform as a joint venture. Previously, small businesses could avoid affiliation for size determination purposes only for contracts that were either bundled or met certain dollar thresholds. The final rule removes these provisions limiting joint venture opportunities only to bundled or large procurements. As a result, the exception from affiliation for small business joint ventures applies to any contract regardless of dollar amount, freeing such joint ventures to pursue contracts of any size.

Recertification

The proposed rule purported to "clarify" that if a firm undergoes a merger or acquisition after it has submitted an offer on a government contract but prior to the award, then the firm would be required to recertify its size to the contracting officer prior to award. Previously, SBA regulations required recertification of contracts after a merger or acquisition but did not expressly address recertification of pending offers. The final rule makes clear that a concern with a pending proposal on a set-aside contract must recertify its size for that pending proposal if it undergoes a merger or acquisition event.

Non-Manufacturer Rule Thresholds

The non-manufacturer rule requires that, for small business set-aside contracts for manufactured items, the prime contractor must either manufacture the items itself or acquire them from another small business. The proposed rule clarified that the non-manufacturer rule does not apply to contracts valued between $3,500 and $150,000. The final rule adopts this exclusion, which is consistent with the broader exclusion of such contracts from the Limitation on Subcontracting requirements.

Non-Manufacturer Rule Waivers after Solicitations

The proposed rule authorized a waiver of the non-manufacturer rule for an individual contract award after a solicitation has been issued as long as all potential offerors are provided additional time to respond. The final rule adopts the proposed rule without significant changes in this regard.

Application of Non-Manufacturer Rule to Commercially Available Software

The proposed rule classified unmodified, commercially available software supplied in procurements governed by NAICS code 511210, Software Publishers, as an item of supply instead of a service. This change, implemented through a new footnote 20 to NAICS 511210 in the SBA Table of Size Standards, would mean that the non-manufacturer rule applies to procurements for this type of software. The rule also specifically authorizes SBA to grant waivers of the requirement to supply the end item of small business manufacturer in such procurements. The rule would not, however, apply to customized software, as this type of procurement is classified as a service contract. The final rule adopts the proposed rule without significant changes in this regard.

CLOSING OBSERVATIONS

Of importance, the final rule states that it is effective on June 30, 2016, but many of these changes, including the Limitation on Subcontracting and

similarly situated entity changes, will also require a change to the Federal Acquisition Regulation ("FAR"). Those revised FAR clauses and provisions will then be added to solicitations or to contracts by way of modification.

A second SBA rulemaking is pending regarding Mentor-Protégé Program changes that will also address other issues regarding the 8(a) program. Like the May 31 final rule, many of these forthcoming changes were mandated by the NDAA of 2013 and prior legislation.