888 17th Street, NW, 11th Floor
Washington, DC 20006
Tel: 202-857-1000
Fax: 202-857-0200

PilieroMazza Breakfast Seminar

MAXIMIZING YOUR TIME AS A SMALL BUSINESS

MAY 26, 2011

Presented by

Jon Williams
Dean Nordlinger

Overview

- **Background**
- **Protecting your small business status**
    1. Use joint ventures
    2. Avoid affiliation
    3. Corporate planning and (re)structuring
    4. Market your customers to assign different NAICS codes
    5. Diversify your business
    6. Examine your fiscal year and tax returns
    7. Create a new company?
- **What to do when you cannot avoid losing your small business status**
    1. Use mentor/protégé joint ventures
    2. Subcontract with small businesses
    3. Acquire or Be Acquired

BACKGROUND

What is a "Small" Business?

- **Small Business Act: A "small business" is a concern that is "independently owned and controlled" and "is not dominant in its field of operation"**
- **As implemented by the SBA, the definition of a small business varies from industry to industry**

1. Industries are assigned codes under the North American Industry Classification System ("NAICS")
2. Each NAICS code has a "size standard" that defines what it means to be a small business in the corresponding industry
3. Size standards are expressed as total number of employees or three-year average total revenues
4. Generally speaking, the SBA has assigned employee-based size standards to the manufacturing industries, and revenue-based size standards to the construction and services industries

Changes to the Size Standards

- **The SBA is in the process of overhauling the size standards for the first time in many years**
  1. October 2010 – The SBA finalized increases to size standards for a number of industries within NAICS Sectors 44-45 (Retail Trade), Sector 72 (Accommodations and Food Services), and Sector 81 (Other Services)
  2. March 2011 – The SBA proposed increases to size standards for 35 industries and one sub-industry within NAICS Sector 54 (Professional, Scientific, and Technical Services); comments due June 15, 2011

- **The Small Business Jobs Act of 2010 requires the SBA to conduct a detailed review of at least one-third of all size standards every 18 months**
  1. Once the proposed increases for Sector 54 and 81 are finalized, perhaps as soon as Fall 2011, the SBA will move on to another group of industries
  2. Your industry could be next!

Why Size Matters

- **Being "small" is the essential ingredient of all federal small business contracting programs**
  1. A concern must be "small" for admission into certain SBA small business contracting programs, such as the 8(a) and HUBZone programs
  2. A concern also must be "small" to compete for and win a procurement set-aside for small businesses
  3. Therefore, if you are in the small business programs or compete for set-aside contracts, your small business status is one of your most important assets

- **Being "small" exempts you from certain requirements**
  1. Reporting executive compensation
  2. Ethics awareness and compliance program under FAR § 52.203-13
  3. Cost Accounting Standards

How Size Is Determined

- **Calculating Size by Average Annual Receipts:** Size determined by a concern's "average annual receipts" plus its affiliates' average annual receipts
    1. Basically, "total income" plus "cost of goods sold" (as these terms are defined by the IRS)
    2. Certain exclusions (examples)
        - Sales taxes and franchise taxes collected for and remitted to a taxing authority
    3. Typically, average annual receipts determined by federal income tax returns and any amendments

- **Period of measurement:** Annual receipts of a concern that has been in business for three or more completed fiscal years means the total receipts of the concern over its most recently completed three fiscal years divided by three

The SBA's "Former Affiliate" Rule

- When determining a concern's size, average annual receipts of a former affiliate are <u>not</u> included <u>if</u> affiliation ended before the date used to determine size
- Exclusion applies for the <u>entire measurement period</u> and not just the period after the affiliation ended
- <u>Note</u>: sale of a "division" of a concern, even if it's a segregated, stand-alone operating division, is <u>not</u>, and <u>cannot</u> be treated as, a "former affiliate" for determining size

Illustration of "Former Affiliate" Rule

- **Company X's Average Annual Receipts of $7 Million**
  1. Company X and its 3 subsidiaries have average annual receipts of $7 million as of January 1, 2011, based on 2008, 2009, and 2010 revenues (assume fiscal year is calendar year)
  2. Company X's average annual receipts are $4 million
  3. Company X's subsidiaries – Sub X1, Sub X2, and Sub X3 – each have average annual receipts of $1 million

- **Sale of Company X's Subsidiary Reduces Average Annual Receipts to $6 million**
  1. As of February 1, 2011, Company X has sold Sub X2 to an unrelated 3rd party
     - Assume relationship with Sub X2 is fractured in connection with the sale
  2. As of March 1, 2011, Company X bids on a new procurement with a NAICS code size standard of $6.25 million

Illustration of "Former Affiliate" Rule

(continued)

3. Company X would be eligible to bid on this procurement because affiliation with Sub X2 ended February 1, 2011, and date used for determining size is March 1, 2011. As of March 1st, Company X's average annual receipts for 2008, 2009, and 2010 are $6 million (not $7 million) because Sub X2's revenues are excluded under the "Former Affiliate" Rule
   - Sub X2's average annual receipts for the entire measurement period are excluded

PROTECTING YOUR SMALL BUSINESS STATUS

Use Joint Ventures

- **What is a joint venture?**

  Commonly defined as "an association of concerns with interests in any degree or proportion by way of contract, express or implied, consorting to engage in and carry out a specific business venture for joint profit, for which purpose they combine their efforts, property, money, skill, or knowledge, but not on a continuing or permanent basis for conducting business generally."

- **Characteristics of a joint venture**

  1. Partnership or limited liability company
  2. Shared profits and losses
  3. Co-management
  4. Limited duration
  5. Affiliation

Use Joint Ventures

(continued)

- **Advantages**

  1. JV revenue is attributed to the JV partners in proportion to their ownership interests in the JV
  2. Shared resources and experience at prime contract level
  3. Relatively easy to set up
  4. JV partners can receive favorable partnership tax treatment

- **Drawbacks**

  1. For set-aside contracts, your JV partner must be an eligible small business or SBA-approved mentor
  2. Affiliation concerns
  3. Your partner must be the right fit for your company
  4. Limits on the number of contracts that can be performed through JVs

- **Bottom line:** JVs reduce contract revenue attributed to your firm, allowing you to stay a small business longer while still gaining experience at the prime contract level

Avoid Affiliation

- **What is affiliation?**

  Two firms are deemed to be affiliated when one firm has the power to control the other, or when both firms are controlled by a third. To the SBA, "[i]t does not matter whether control is exercised, so long as the power to control exists." Control may be affirmative or negative and may be found when control is exercised indirectly through a 3rd party. Any business entity can be an affiliate, including concerns located outside of the U.S. and non-profits.

- **Examples of what causes affiliation**

  1. Common ownership and management
  2. Shared facilities and employees
  3. Newly organized concern
  4. Joint ventures
  5. Significant percentage of revenue from contracts with one company
  6. The "totality of the circumstances"

Avoid Affiliation

(continued)

- **What does it mean to be affiliated?**

  When determining if a firm is a small business, the SBA aggregates the average annual revenues or total number of employees for the firm and all of its affiliates

- **How to avoid affiliation**

  1. Understand the various ways that affiliation can occur
  2. Proactively assess the potential for affiliation prior to corporate transactions
  3. Be wary of corporate documents that give another party "negative control" over your business
  4. Diversify your teaming partners and sources of revenue
  5. Do not assume your family member's business is unaffiliated with your firm
  6. Make sure your website and marketing materials do not create an impression of affiliation with other firms

Corporate Governance Issues

- **Make sure your governing documents (articles/certificate of incorporation or organization/formation, bylaws, shareholders agreement, or operating agreement) do not contain "negative control" provisions which could cause affiliation**
    1. Super-majority or unanimity voting requirements on material business decisions (which affects the owner's ability to manage and conduct the company's business)
    2. Quorum requirements by which minority owner could prevent the majority owner from conducting company business

Use Corporate Planning and the "Former Affiliate" Rule

- **(1) Planning Early On; (2) Planning In the Middle; and (3) Planning Toward the End**
- **Does your company have operating divisions that are naturally separable or are otherwise operated on a segregated, stand-alone basis?**
    1. If so, you may be able to use the "former affiliate" rule to reduce your revenues by divesting operating divisions or subsidiaries
    2. Remember that when the "former affiliate" rule is triggered, you can exclude the former affiliate's revenues during the entire three-year period of measurement

Corporate Planning Options

- **<u>Planning Early On (at formation or early in the life cycle of the company)</u> - More Advantageous Approach**
  1. Start a subsidiary (and not a stand-alone operating division in parent company)
  2. Creates clear history of "separateness" between parent and subsidiary
  3. Avoids need to assign and transfer prime contracts between affiliates and otherwise to deal with novation or exemption from novation ("corporate reorganization")
  4. Positions company for more flexible sale of subsidiary to an unrelated 3rd party
     - Sale could be structured as an asset deal, stock deal, or a merger

Corporate Planning Options

(continued)

- **<u>Planning In the Middle (once the company has substantial business and operations)</u> – A Manageable Approach**
  1. Drop stand-alone operating division into a subsidiary once Company has substantial business and operations
  2. Creates a track record of "separateness" (even if not a full three years) between parent and subsidiary
  3. Provides sufficient time to assign and transfer prime contracts between affiliates and otherwise to deal with novation or exemption from novation ("corporate reorganization")
  4. Provides sufficient time to assign and transfer other contracts – deal with other 3rd party consents (such under subcontract agreements, real property leases, and other commercial contracts)
  5. Positions company for more flexible sale of operating division (new subsidiary) to an unrelated 3rd party (structure as an asset deal, stock deal, or a merger)

Corporate Planning Options

(continued)

- **<u>Planning Toward the End</u> – More Difficult Approach**
  1. Drop stand-alone operating division into a subsidiary close in time to sale of line of business
  2. No real track record of "separateness" between parent and subsidiary
  3. Going forward, company more vulnerable to size protest post-sale of subsidiary – that the prior line of business/operating division revenue should be counted in determining the company's size
     - But, helpful mitigating factors, if true, would be: (1) parent discontinuing line of business in which subsidiary operates; and (2) when operated as a division by parent, was a segregated, stand-alone operating division

Corporate Planning Options

(continued)

4. Provides minimal if not insufficient time to assign and transfer prime contracts between affiliates and otherwise to deal with novation or exemption from novation ("corporate reorganization"), and other 3rd party consent matters
   - Additional challenge of occurring so close in time to a subsequent asset deal or stock deal with an unrelated 3rd party which could trigger full novation requirements
5. If not completed in advance of initiating sale discussion with an unrelated 3rd party offeror, more difficult to convince 3rd party offeror to agree to "drop down" of operating division into a newly created subsidiary company
   - 3rd party offeror likely to push for an asset deal – purchase of operating division directly from company

Implementing Corporate Structuring Options

- **"Drop Down" Operating Division into Subsidiary**
  1. Company "contributes" the operating division into a newly formed subsidiary ("newco") in exchange for a 100% ownership interest in newco (this creates a parent-subsidiary relationship)
  2. At the appropriate time, company effects sale of newco, as an asset deal, stock deal, or a merger
  3. Structure sale to ensure fracture (address common ownership, newly organized concern, and totality of the circumstances issues)

Implementing Corporate Structuring Options

(continued)

- **<u>Corporate Reorganization: Spin-Off Transaction</u>**

  1. Company creates a subsidiary (drop down operating division into it), then distributes the 100% ownership interest in newco *pro rata* to the company's existing shareholders
  2. Shareholders now own company and subsidiary as "sister companies" (with identical ownership structure in the sister companies)
  3. If structured properly and done substantially in advance of any sale of either sister company to an unrelated 3rd party, could possibly be done tax-free (significant tax-related requirements must be met)
  4. Affiliation still exists post spin-off, but at appropriate time, shareholders could fracture the relationship between sister companies by sale of one company to an unrelated 3rd party offeror
     - To ensure fracture, address common ownership, newly organized concern, and totality of the circumstances issues

Implementing Corporate Structuring Options

(continued)

- **Corporate Reorganization: Split-Off Transaction**

1. Company creates a subsidiary (drop down operating division into it), then distributes the 100% ownership interest in newco to one or more of the company's existing shareholders who, in exchange, surrender part or all of their stock in the company
   - Note: main difference in spin-off versus split-off – in a split-off, company shareholders have to surrender some or all of their stock in exchange for stock of newco
2. If structured properly, could be done tax-free (significant tax-related requirements must be met)
3. If structured properly, affiliation could be fractured at the appropriate time as part of the split-off transaction
   - To ensure fracture, address common ownership, newly organized concern, and totality of the circumstances issues

Market Your Customers to Assign Different NAICS Codes

- **Contracting officers assign an NAICS code and accompanying size standard to set-aside procurements**
  1. The assigned NAICS code is supposed to best describe the "principal purpose" of the solicitation
  2. To determine principle purpose, the contracting officer must compare the NAICS code description to the products or services being solicited, which includes reviewing the relative value and importance of the supplies or services that make up the end item being procured and the functions of the goods and services being purchased
  3. Other considerations include the NAICS codes assigned to prior, similar procurements
- **Use meetings, letters, and white papers to contracting personnel to advocate for a different NAICS code that has a higher size standard**
- **Challenge assigned NAICS codes to the SBA OHA**

Diversify and Develop Business Under Other NAICS Codes

- **Build up capabilities to pursue work under different NAICS codes by organic growth or growth through acquisition**

  1. Organic growth = internally building up capabilities and hiring new personnel
  2. Acquisition growth = acquiring other concerns with desired capabilities and expertise so that company can pursue (directly or through newly acquired concern) new business under NAICS codes with higher revenue thresholds

- **Ultimately, this may better prepare a company to "blow through" and not just trip over the line between being small and "other than small" and, once no longer small, better position and prepare a company to compete against large businesses in the space**

Create a New Company?

- **Frequently Asked Question:** To stay small, can a company or the owners of a company just create a new company and run new business through it?

- **Short Answer:** No. The simple act of creating a new company does not negate the common ownership, newly organized concern, and totality of the circumstances issues that lead to affiliation for size purposes. However, in theory, if the new business has different ownership, management, and operations, this could work. But creating such a different company defeats the purpose for why most business owners would want to do this.

Change Your Fiscal Year

- **You may be able to alter your fiscal year to recast your average annual receipts, thereby giving you another year to operate as a small business under a particular size standard**
- **Changing your fiscal year will create a "short year"**
  1. The SBA will calculate revenues based on total number of weeks during the three-year period in question, so this may not help if your revenues are evenly distributed throughout the year
  2. However, if your revenues are back-loaded, changing fiscal year from calendar year-end to an earlier date may reduce your average revenues
  3. At best, this is a short-term fix
- **Must be legitimate business reasons to change fiscal year beyond desire to prolong small business status, and may require IRS approval**
  1. Change for accounting reasons, such as to match government fiscal year or contract years

Examine Your Tax Returns

- **Careful Analysis and Calculation of Average Annual Receipts:** A thorough review of average annual receipts – "total income" plus "cost of goods sold" – could help prevent accidental inclusion of items that should be excluded (such as sales taxes and franchise taxes) and could drive up and lead to overstating the average annual receipts

- Amended tax returns must be filed prior to submission of proposal for a set-aside contract, or they will not be utilized in determining your size

WHAT TO DO WHEN YOU CANNOT AVOID LOSING YOUR SMALL BUSINESS STATUS

Find a Protégé

- **Many federal agencies have mentor-protégé programs that offer contracting advantages to mentors**
  1. New SBA rules indicate that the SBA will only recognize programs authorized by statute, such as the DOD mentor-protégé program
- **Only the SBA's mentor-protégé program allows for joint ventures between the mentor and the protégé**
  1. Protégé must be an 8(a) firm and control the JV
  2. Mentor may perform up to 60% of the JV work
  3. M-P JV may be used for 8(a), small business, and SDVOSB contracts
  4. M-P JV allows you to compete for follow-on set-aside contract that you are no longer eligible to perform on your own

Subcontract with Small Businesses

- **Pursue teaming and subcontract agreements with small businesses for set-aside contracts**

  1. Depending on the nature of the contract, subcontractors may perform as much as 50% to 85% of the contract with their own personnel
  2. Subcontractors cannot perform all of the "primary and vital" requirements of the contract
  3. Teaming agreement should assign discrete tasks to the subcontractor and should take other steps to avoid ostensible subcontractor affiliation

Acquire or Be Acquired by Another Business

- Use acquisitions to better prepare the company for its life as "other than small" to compete with larger businesses
- Ultimately, this may better prepare a company to "blow through" and not just trip over the line between being small and large and, once no longer small, better position and prepare a company to compete against large businesses in the space