

**ECONOMICALLY DISADVANTAGED STATUS OF AN 8(a)
PROGRAM PARTICIPANT'S OWNER**

REPORT NUMBER 6-32

SEPTEMBER 25, 2006



**U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
WASHINGTON, D.C. 20416**

MANAGEMENT ADVISORY REPORT
Issue Date: September 25, 2006
Report Number: 6-32

TO: Joseph P. Loddo
District Director, Washington Metropolitan Area District Office

Luz Hopewell
Associate Administrator for Business Development

/s/ original signed

FROM: Debra S. Ritt
Assistant Inspector General for Auditing

SUBJECT: Economically Disadvantaged Status of an 8(a) Program Participant's
Owner

The Office of Inspector General (OIG) received an anonymous complaint regarding a company in the 8(a) Business Development program. The complainant stated that the company received an unfair share of 8(a) contract awards from the Small Business Administration (SBA). While researching this complaint, the OIG determined that the company's owner is the future beneficiary of a trust, a portion of which was valued at [EXEMPTION 4].

In reviewing the complaint, the OIG assessed whether the trust should be considered the owner's asset for the purpose of determining whether the owner is economically disadvantaged for 8(a) program eligibility. We reviewed the company's 8(a) files and a prior audit report on the company to obtain background concerning the owner and the company. We also reviewed the Small Business Act, 13 Code of Federal Regulations (CFR), the 8(a) program Standard Operating Procedures (SOP), the Small Disadvantaged Business Training Manual, and interviewed agency officials.

BACKGROUND

SBA's 8(a) program was created to help small businesses owned by socially and economically disadvantaged individuals compete in the American economy and access the federal procurement market. Socially disadvantaged individuals are those who have

been subjected to racial or ethnic prejudice or cultural bias within American society because of their identities as members of groups and without regard to their individual qualities. Economically disadvantaged individuals are socially disadvantaged individuals whose ability to compete in the free enterprise system has been impaired due to diminished capital and credit opportunities as compared to others in the same or similar line of business who are not socially disadvantaged.

In considering diminished capital and credit opportunities, SBA considers the personal financial condition of any individual claiming disadvantaged status, including personal income for the past 2 years (including bonuses and the value of company stock given in lieu of cash), personal net worth, and the fair market value of all assets, whether or not encumbered. SBA will also consider the financial condition of the applicant compared to the financial profiles of small businesses in the same primary industry classification, or, if not available, in similar lines of business.

Program participants can receive substantial benefits, including sole-source contracts, business development grants, low-interest loans, and free management consulting services. The 8(a) program is not intended to assist companies owned and controlled by socially disadvantaged individuals who have accumulated substantial wealth, have unlimited growth potential, or who can obtain access to financing, markets and resources. For example, a participant is ineligible to remain in the 8(a) program if its disadvantaged owner's net worth (excluding the value of his/her personal residence and the equity in the 8(a) company) equals or exceeds \$750,000. The 8(a) program requirements are contained in 13 CFR § 124.

RESULTS

The company's owner is the future recipient of a trust, a portion of which is valued at [EXEMPTION 4]. SBA was unaware of the trust's existence when making initial and continuing 8(a) eligibility determinations for the company. The trust has provided the owner with [EXEMPTION 4] in capital and the company with [EXEMPTION 4] in credit. Despite the fact that capital and credit opportunities are available to the owner, the trust is not currently considered an asset since the company's owner does not have direct access to the funds most of the time. While the trustees must authorize the release of funds to the owner, clearly a loophole exists in the regulations that allows companies owned by individuals that have access to capital and credit, i.e. non-disadvantaged, to obtain 8 (a) contracts. Participation by non-disadvantaged individuals reduces the opportunities available to those who are legitimately disadvantaged, diverts the energy and efforts of the SBA, and could undermine public support for the program. While our review focused on one company, and we do not know if the issues raised in this report are a widespread problem, SBA should determine whether changes in regulations are needed to address contingent assets, such as a trust.

The owner's economic disadvantage status will change when he receives one-eighth of the value of the trust on [EXEMPTION 6]. At that time, SBA will need to make a determination on the participant's status and program eligibility.

The Trust has made a Direct Payment to the Owner and Extended Credit to the Company

The President and sole owner of the company is the future beneficiary of an irrevocable trust, a portion of which is valued at [EXEMPTION 4]. The trust is managed by three trustees, two of whom are apparently related to the owner, who are responsible for investing the trust funds as well as maintaining the fund, (i.e., paying taxes and professional fees). According to the trustees, the remainder of the trust is “illiquid,” and could not be valued. The trustees must authorize the release of funds to the owner, except when a contribution is made to the trust. The owner can withdraw the entire contribution within 30 days of the trust’s receipt of the contribution.

Over the past 7 years, the trustees paid the owner [EXEMPTION 4], loaned the owner’s 8(a) company [EXEMPTION 4], and guaranteed an [EXEMPTION 4] line of credit for the 8(a) company with the trust’s assets. On [EXEMPTION 6], one-eighth of the trust fund balance, or approximately [EXEMPTION 4] will be distributed to the company’s owner. When this distribution occurs, the owner’s net worth should exceed the \$750,000 8(a) program limit. The owner will receive additional distributions from the trust until 2017, when the trust will be dissolved and the remaining value disbursed to the owner.

The Trust Is Not Considered the Owner’s Asset at this Time Under SBA Regulations

For continued 8(a) eligibility after admission to the program, the owner’s net worth must be less than \$750,000. In determining such net worth, SBA excludes the owner’s interest in the 8(a) company and the equity in his/her primary personal residence. Further, based on the terms of the trust, the owner cannot assign any of his interests in any distributions from the trust until they occur. Because the owner does not have direct control over the trust’s assets at this time, the trust is considered a contingent asset for purposes of determining the owner’s net worth. Although the 8(a) SOP directs that contingent liabilities are not considered in determining net worth, it does not address contingent assets. An SBA official who performs 8(a) eligibility reviews and certifications stated that SBA cannot make a strong case that the company has access to capital and credit based solely on the trust providing the 8(a) company a [EXEMPTION 4] loan and guaranteeing a [EXEMPTION 4] \$850,000 line of credit because these amounts were not significant for an industry with a size standard exceeding \$20 million. In determining whether a company has access to capital and credit, we were told that SBA looks at the totality of the circumstances.

SBA examines four factors in considering diminished capital and credit opportunities: the owner’s net worth, the owner’s total assets, the owner’s personal income, and the company’s financial condition compared to businesses in the same or similar line of business. The trust, a contingent asset, is not included in determining any of these factors. If the trust’s assets are not included, the owner and the company do not

exceed the limits on any of these factors. Therefore, according to SBA's regulations the owner has diminished capital and credit opportunities and is economically disadvantaged.

Excluding Contingent Assets When Determining Access to Capital and Credit Can Undermine the Integrity of the Program

The 8(a) program was not developed to assist socially disadvantaged individuals who have overcome impediments to obtaining access to financial markets and resources. However, it is evident that the trust provided the owner and the 8(a) company access to capital and credit, which small business entrepreneurs without a "contingent asset" do not have.

Companies owned by individuals who have indirect access to capital and credit can be eligible for the 8(a) program because SBA regulations do not address owners who are in this situation. While the access is indirect, at least in this instance, it provided actual capital and credit to the owner and the company. It is entirely possible that, if needed, the trust would continue to provide the owner and/or the company significant additional capital and credit. As a result, the company receives the benefit of participating in the 8(a) program, although the company and its owner have access to capital and credit. Consequently, this company is eligible to receive 8(a) contracts that could have gone to other 8(a) companies that do not have this competitive advantage.

While this situation may be an isolated situation, SBA should determine whether contingent assets need to be addressed in its regulations concerning economic disadvantage.

RECOMMENDATIONS

We recommend that the District Director of the Washington Metropolitan Area District Office:

1. Determine whether the company's owner is economically disadvantaged when he receives one-eighth of the trust's value on [**EXEMPTION 6**].

We recommend that the Associate Administrator for Business Development:

2. Determine whether contingent assets such as trusts should be considered when assessing economic disadvantage and whether any regulation changes on this are needed.

SBA MANAGEMENT'S RESPONSE AND OIG'S EVALUATION OF MANAGEMENT'S RESPONSE

The District Director of the Washington Metropolitan Area District Office concurred with the OIG recommendation addressed to him. The District Director agreed to determine whether the company's owner is economically disadvantaged when he

receives one-eighth of the trust's value on [EXEMPTION 6]. His proposed action is responsive to recommendation 1. The District Director's response is included as Appendix 1.

The Associate Administrator for Business Development's response stated that she would determine whether contingent assets are addressed in the regulations and will include the issue in training and possibly an update to 13 CFR § 124 by September 30, 2007. This proposed action is responsive to recommendation 2. The Associate Administrator's response is included as Appendix 2.

* * * * *

The recommendations in this report are the conclusions of the Office of Inspector General's Auditing Division. The recommendations are subject to final action by your offices in accordance with existing Agency procedures for audit follow-up and resolution.

Should you or your staff have any questions, please contact Robert G. Hultberg, Director, Business Development Programs Group at (202) 205-[EXEMPTION 2]



U. S. SMALL BUSINESS ADMINISTRATION
WASHINGTON METROPOLITAN AREA DISTRICT OFFICE
740 1st Street, N.W., 3rd FLOOR
WASHINGTON, DC 20005
202-272-0340
www.sba.gov/dc

Office of the District Director

September 13, 2006

Mr. Marc Bickoff
Audit Manager
U.S. Small Business Administration
Office of Inspector General
409 3rd Street, S.W.
Washington, D.C. 20416

Dear Mr. Bickoff:

Thank you for your Draft Management Advisory Report of August 18, 2006. Program Integrity in the 8(a) program is of utmost importance to the Washington Metropolitan Area District Office.

I have reviewed the documentation presented and will make a determination whether company's owner is economically disadvantaged when he receives one-eighth of the trust's value on EXEMPTION 6

Please do not hesitate to contact me if you have any questions or comments.

Sincerely,

EXEMPTION 6

Joseph P. Laddo
District Director



U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

DATE: September 20, 2006

TO: Debra S. Ritt
Assistant Inspector General for Auditing

FROM: *LR* EXEMPTION 6
LIZ A. HOPWELL
Associate Administrator for Business Development

SUBJECT: Response to Draft Management Advisory on the Economically Disadvantaged status of an 8(a) Program Participant's owner

CC: Calvin Jenkins, Deputy Associate Deputy Administrator, GC/BD EXEMPTION 6

The Office of Business Development is pleased to provide a response to the draft management advisory audit entitled "Economically Disadvantaged status of an 8(a) Program Participant's owner", dated August 18, 2006.

Thank you for your support throughout this process. Please address any questions you have concerning this matter to Jacqui West (202) 205- EXEMPTION 2

Attachment

ATTACHMENT

Response to IG Draft Audit Recommendations

SBA Program: *Office of Business Development*

Report Title, Number: Economically Disadvantaged status of an 8(a) Program Participant owner

Report Issue Date: *August 18, 2006*

Recommendation 2

"We recommend the Associate Administrator for Business determine whether contingent assets such as trust should be considered when assessing economic disadvantage and whether or not any regulatory changes are needed on this.

SBA Response: The Associate Administrator for Business Development will review the current regulations to determine whether the issue of contingent assets is addressed and will include this issue in both training and in a possible update to the regulations at 13 CFR, Part 124.

Target Date for Final Action: September 30, 2007

REPORT DISTRIBUTION

<u>Recipient</u>	<u>No. of Copies</u>
Associate Administrator for Field Operations.....	1
Associate Deputy Administrator for Government Contracting and Business Development	1
Deputy Associate Deputy Administrator for Government Contracting and Business Development	3
Office of the Chief Financial Officer Attention: Jeffrey Brown	1
General Counsel.....	3
U.S. Government Accountability Office	2