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ALERT

SBA Changes Limitations on Subcontracting Requirements

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On May 31, 2016, the Small Business Administration (SBA) issued a final rule implementing the small business-related provisions in the FY13 National Defense Authorization Act (NDAA). The final rule includes significant changes to the methodology for calculating the amount of work that must be performed by a small business prime contractor under a set-aside contract, commonly known as the limitations on subcontracting or the "50 percent rule." The rule also includes a new exemption for amounts spent on "similar situated entity" subcontractors.

As discussed previously when SBA issued its proposed rule, the new methodology does away with the old version of the "50 percent rule," which required a calculation of the percentage of contract costs incurred by the prime contractor and its subcontractors. That calculation was often difficult to perform in practice and had never been consistently applied by government agencies or industry. The new methodology is a much simpler calculation based on total payments by the government to the prime contractor.

Specifically, the new rule requires prime contractors under small business set-aside contracts to agree that they will not pay more than a certain percentage of the amount they receive from the government to subcontractors. The percentage is 50% for services and supply contracts, and 85% for construction contracts. The substance of the limitations on subcontracting has not changed—the prime contractor still must perform 50% (or 15%) of the work. But the rule creates a new methodology for ensuring compliance with the limitations on subcontracting by focusing on the amount paid to subcontractors.

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The final rule also relaxes the performance requirements for small business prime contractors by effectively allowing them to count work performed by other small businesses as their own. The new rule does not count work performed by "similarly situated entities" as subcontracted work for purposes of determining compliance with the limitation on subcontracting requirements. Thus, if a small business prime contractor performs 35% of the work and one of its small business subcontractors performs 15% of the work, the prime contractor will have met the limitations on subcontracting.

A similarly situated entity is defined as a small business subcontractor that is a participant of the same small business program as the prime contractor, and is small for the NAICS code assigned by the prime contractor to the subcontract. Only a first-tier subcontractor, however, can be counted as a similarly situated entity, and the first-tier subcontractor must perform the work with its own employees to receive the benefit of the similarly situated entity exemption. All work performed by lower-tier subcontractors will be treated as work performed by non-similarly situated entities. In other words, the 50% performance requirement must be met by the prime contractor and its similarly situated first-tier subcontractors. Work performed by second-tier (and lower) subcontractors will count towards the limitation on subcontracting, even if it is performed by small businesses.

For total or partial set-aside contracts, the period of time used to calculate compliance with the limitations on subcontracting will be the base term and then each subsequent option period. For task orders issued under total or partial set-aside contracts, the contracting officer can also require the firm to comply with the limitations on subcontracting for each order. For task orders set aside for small business under full-and-open contracts, the agency will use the period of performance for each order to determine compliance.

Unlike the proposed rule, the final rule does not include a requirement for written agreements between prime contractors and similarly situated subcontractors prior to award, or regular reporting to the SBA on compliance with limitation on subcontracting requirements and the similarly-situated entity exception. After reviewing comments to the proposed rule, the SBA felt that other reporting requirements were sufficient to track and identify subcontracts, that requiring pre-award agreements would unduly hamper contractors' flexibility, and that this requirement would impose too much of a burden on the SBA to review those agreements.

As is typical for changes to SBA regulations, there will be some "lag time" before the new requirements are reflected in the FAR. The current FAR clause addressing limitations on subcontracting, FAR 52.219-14, still includes the old methodology based on the cost of contract performance. Until the FAR is changed to reflect the new methodology, contractors should expect to see some confusion among contracting officers about which rule applies.