

## TRANSFERRING SBA BUSINESS ENTITIES INTO A REVOCABLE TRUST

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October 2018

When a business owner creates a revocable trust, we often recommend that the owner transfer his or her business interests into the trust to fully take advantage of the estate planning benefits associated with having a trust. However, if the business is a certified small business, it is important to ensure that the terms of the trust comply with the applicable federal regulations prior to transfer of the business into the trust. This Client Alert discusses certain types of small business entities, and the federal regulations that must be adhered to, in order to effectively transfer the business into a trust while also maintaining the business's certified small business status. Please understand that the following discussion provides a brief overview and should not be relied upon for legal advice. Some nuances are beyond the scope of this Client Alert and the various regulations discussed are subject to change.

### **Economically Disadvantaged Women Owned Small Business and Women Owned Small Business**

To qualify as an Economically Disadvantaged Women Owned Small Business ("EDWOSB") or a Women Owned Small Business ("WOSB"), the concern must be a small business that is unconditionally and directly owned and controlled by one or more women who are United States citizens. In addition to the above requirements, to qualify as an EDWOSB, the concern must be owned and controlled by one or more women that are economically disadvantaged. 13 C.F.R. § 127.200. In order to satisfy the requirement for unconditional ownership, "the ownership must not be subject to any conditions, executory agreements, voting trusts, or other arrangements that cause or potentially cause ownership benefits to go to another." 13 C.F.R. § 127.201(b). In order to satisfy the requirement for direct ownership, the 51% interest owned by the qualifying women "may not be through another business entity or a trust (including employee stock ownership plan) that is, in turn, owned and controlled by one or more women or economically disadvantaged women." 13 C.F.R. § 127.201(c).

While the preceding sentence appears to suggest that an EDWOSB or a WOSB cannot be owned by a trust, the last sentence of 13 C.F.R. § 127.201(c) provides additional clarification regarding ownership requirements: "However, ownership by a trust, such as a living trust, may be treated as the functional equivalent of ownership by a woman or economically disadvantaged woman where the trust is revocable, and the woman is the grantor, the trustee, and the sole current beneficiary of the trust." Therefore, so long as the trust is revocable, and the woman is the grantor, trustee and the sole current beneficiary of the trust, an EDWOSB or a WOSB can be owned by a trust. If such an entity is transferred to a trust, it is important for the concern to update its EDWOSB or WOSB certifications and representations to ensure that its records are current, accurate and complete. See 13 C.F.R. § 127.300(f).

### **8(a) Business Development Program**

In order for a business to qualify for the 8(a) program a business must, among other requirements, be at least 51% owned and controlled by U.S. citizens who are economically and

socially disadvantaged. See 13 C.F.R. § 124. As with the federal regulations for a WOSB and an EDWOSB, the code provides further clarification regarding whether or not an 8(a) concern can be owned by a trust. 13 C.F.R. § 124.105(a) states as follows: “Ownership must be direct. Ownership by one or more disadvantaged individuals must be direct ownership. An applicant or Participant owned principally by another business entity or by a trust (including employee stock ownership trusts) that is in turn owned and controlled by one or more disadvantaged individuals does not meet this requirement. However, ownership by a trust, such as a living trust, may be treated as the functional equivalent of ownership by a disadvantaged individual where the trust is revocable, and the disadvantaged individual is the grantor, a trustee, and the sole current beneficiary of the trust.” Thus, if the recipient trust is revocable and names the disadvantaged individual as the grantor, trustee, and sole current beneficiary of the trust, the 8(a) concern can be transferred to the trust without jeopardizing its 8(a) certification status.

### **Service-disabled Veteran-Owned Small Business Program**

To qualify as a Service-disabled Veteran-Owned Small Business (“SDVOSB”), a business must: i) be small, ii) be at least 51% owned and controlled by one or more service-disabled veterans, and iii) have one or more service-disabled veterans manage the day-to-day operations and make the long-term decisions. Any service-disabled veteran must have a service-connected disability for purposes of the above tests. See 13 C.F.R. § 125 Subpart B.

Again, federal regulations addressing the ownership requirements for SDVOSBs specifically address a SDVOSBs ownership by a revocable trust: “Ownership by one or more service disabled veterans must be direct ownership. A concern owned principally by another business entity that is in turn owned and controlled by one or more service-disabled veterans does not meet this requirement. Ownership by a trust, such as a living trust, may be treated as the functional equivalent of ownership by service-disabled veterans where the trust is revocable, and service-disabled veterans are the grantors, trustees, and the current beneficiaries of the trust.” See 13 C.F.R. § 125.12(a).

Caselaw also demonstrates that SDVOSBs can be owned by trusts. “Direct ownership means that a service-disabled veteran owns their business without any intervening entities, such as an ESOP trust. There is a narrow exception where direct ownership may be found via a trust where the service-disabled veteran is the grantor, trustee, and current beneficiary of the revocable trust.” SBA No. SDV-105 (S.B.A.), 2006 WL 4726737. The Court of Federal Claims also addressed this issue in *Precise Sys., Inc. v. United States*, 120 Fed. Cl. 586, 592 (2015). “[L]iving trusts may be treated as the functional equivalent of ownership by service-disabled veterans where the trust is revocable, and the service-disabled veterans are, at all times, the grantors, trustees, and the current beneficiaries of the trust.” *Id.* (Internal citation omitted). Thus, if the trust is drafted properly, a SDVOSB can be transferred to said trust without forfeiting its status as a SDVOSB.

### **HUBZone SBC**

To qualify as a HUBZone SBC, a concern must i) be a small business, ii) be at least 51% owned and controlled by U.S. citizens, a Community Development Corporation, an agricultural cooperative, a Native Hawaiian organization, or an Indian tribe, iii) have its principal office located in a HUBZone, and iv) have at least 35 % of its employees live in a HUBZone. See 13 C.F.R. §

126.200. Notably, in determining who the SBA regards as an owner of a HubZone SBC, 13 C.F.R. § 126.201 states, in part, as follows: “If a trust owns all or part of the concern, SBA considers each trustee and trust beneficiary to be an owner...”.

Unfortunately, although it is clear that each trustee of the trust would be regarded as an owner of the HUBZone SBC, it is not clear whether the term “beneficiary” only applies to current beneficiaries or also includes contingent beneficiaries. While caselaw is lacking regarding this particular issue, the HUBZone helpline stated to our firm on August 21, 2018 that the persons responsible for HUBZone SBC certification would likely consider all beneficiaries, both current and contingent, to be owners of the HUBZone SBC. Therefore, for a HUBZone SBC entity qualifying because at least 51% of its owners are U.S. citizens, the HUBZone SBC would have to submit proof of U.S. Citizenship (i.e. a birth certificate, current valid U.S. Passport, or Certificate of Naturalization) for at least 51% of the trust’s named beneficiaries- not just the current beneficiaries.

Most trusts name contingent beneficiaries, e.g., children or remote catch-all beneficiaries, to receive trust assets after the death of the current beneficiaries. Based upon the above, a HUBZone SBC would potentially have to submit proof of citizenship for at least 51% of such contingent beneficiaries. The ambiguity in the regulations combined with the apparent broad interpretation by the SBA of the word “beneficiary” may be a disadvantage of transferring a HUBZone SBC to a revocable trust with multiple beneficiaries. We hope that the SBA will clarify its position regarding the expansive use of the term “beneficiary” in the context of the HUBZone program compared to the other programs discussed above that limit the term to “current” beneficiaries. It is not clear why such a difference is warranted.

### **Caveat Emptor**

In addition to complying with the regulatory requirements, a business owner should also consider the possibility that an unhappy competitor may protest an award on the mere “hope” that the trust does not comply with the applicable regulation. An incumbent losing on a re-compete may be tempted to challenge the incoming contractor’s status if the business is owned by a trust without knowing that there is an actual violation of the regulations. The challenger may not have access to the appropriate trust documents in order to determine the validity of a protest or may simply be filing a protest to delay transfer of a contract to the other party.

### **Conclusion**

In sum, it is important for business owners to carefully review the terms of their trusts before transferring their certified small businesses into their trusts. Each concern has its own federal regulations that must be adhered to in order to ensure that the concern does not inadvertently jeopardize its certified status. Business owners also need to consider the possibility that trust ownership, even if correct, will be challenged by an unhappy competitor. Please do not hesitate to contact our firm if you have any questions regarding this topic.

**DISCLAIMER.** This Client Alert does not provide legal advice. We are providing it for general informational purposes only.