United States Small Business Administration
Office of Hearings and Appeals

IN THE MATTER OF:	
Avellan Systems International, Inc.	SBA No. BDP-332
Petitioner	Decided: November 10, 2009

FINAL DECISION

APPEARANCES

Renée Tuck, President, *pro se,* for Avellan Systems International, Inc.

Sara Lipscomb, Mollie B. Gaughan, and Lara H. Hudson for the Small Business Administration's Office of General Counsel.

ISSUES

1. Whether the Small Business Administration (SBA) raised valid privilege claims for eight exhibits in the Administrative Record and whether Avellan Systems International, Inc. (Petitioner) should be allowed to supplement the Administrative Record with copies of State of Utah tax returns for 2006 and 2007.[1]

2. Whether the SBA's determination that Petitioner was ineligible for admission into the 8(a) Business Development Program (8(a) program) is arbitrary, capricious, or contrary to law. *See* 15 U.S.C. § 637(a)(9)(C); 13 C.F.R. § 134.406(b).[2]

BACKGROUND

Petitioner was known as Avellan Systems International, LLC (Avellan LLC), until May 14, 2007, when it was incorporated in the State of Utah. (Exs. 14 at H, I.) The Internal Revenue Service accepted Avellan LLC's election to be treated as a Subchapter S corporation beginning January 1, 2007. Ex. 14 at J. Renée Tuck (Tuck) owns one hundred percent of the shares of, and controls, Petitioner; thus, her status is determinative of petitioner's eligibility. *See* 13 C.F.R.

[1] I will cite to the Exhibits in the Administrative Record as "Ex. __." and to the SBA's Response as "SBA Resp. at __."

[2] There is jurisdiction to decide this appeal and the appeal is timely. *See* 15 U.S.C. § 637(a)(9)(A), (B)(i); 13 C.F.R. §§ 134.102(j)(1), .202(a)(1).

§ 124.106(d)(1)(i). The application included Tuck's individual federal tax returns for 2005, 2006, and 2007 and Petitioner's tax return for an S corporation for 2007. (Ex. 14 at F, G, M, N.)

On January 9, 2009, the SBA denied Petitioner's application for admission into the 8(a) program. The SBA determined that Tuck is a socially disadvantaged person. *See* 13 C.F.R. § 124.103(b). The SBA determined that Tuck was not economically disadvantaged based on her excessive personal income. *See* 13 C.F.R. § 124.104. The SBA explained:

> Based on the information your [adjusted gross income (AGI)] in 2006 was $192,739 and your AGI in 2007 was $363,341. We only had documentation verifying the amount distributed to you by your firm and retained by it in 2007. Specifically, this was evidenced by your 2007 personal and Federal business tax returns. However, no documentation verifying the amounts distributed to you and retained by your firm was provided in 2006. At that time, your firm was a one member LLC and you reported $193,309 in Schedule C income. When making adjustments, SBA has determined that your two-year average of your AGI is $267,708.

Ex. 5 at 2.

In its January 9, 2009, letter denying the application, the SBA explained how it used currently available IRS data to conclude that individuals with two-year personal income of $200,000 or more are not economically disadvantaged. The SBA determined that, in 2005, 3,566,125 individual tax returns (ITR) or 2.65% of the 134,372,678 ITR filed reported an AGI of $200,000 or more. This fact led the SBA to conclude that an individual whose two-year average personal income is $200,000 or more is within the top percentiles of all taxpayers and is not economically disadvantaged. Ex. 5.

On January 19, 2009, Petitioner requested reconsideration, arguing that Tuck's two-year average income was $188,729, below the $200,000 ceiling. Regarding the lack of documentation verifying the amounts retained by Petitioner and distributed to Tuck in 2006, Petitioner responded: "[W]e are attributing the amount of $193,309 as the distribution for the year 2006. In other words, there was no portion of the applicant's income reinvested into the firm during this year and none is being asserted." Ex. 4.

On January 29, 2009, the SBA determined that Petitioner's reconsideration request did not provide sufficient evidence to overcome the original reason for denying the application. The SBA explained:

> In your reconsideration request, you indicate that your adjusted average two year income is $188,729. However, your calculation is not correct. Specifically, when assessing your adjusted average two year income, we included all distributions you received from the applicant firm, such as wages, dividends, interest, and Schedule K-1 distributions, where applicable. Thus, you received total distributions of $405,891 ($30,000 in wages, $5,084 in interest income, and $370,807 in Schedule K-1 distributions) in 2007 and $193,309 in 2006. The

> figure for 2006 is based on the information you provided for reconsideration. However, the total distributions figure indicated by you for 2007 was not correct since you did not include the Schedule K-1 distributions.
>
> We then determined the associated Federal income taxes owed on the taxable income (after adjustments/itemized deductions) reported by you from the applicant firm for each tax period. The Federal taxes for each tax year were then subtracted from the total distributions reported above. This resulted in a net personal income from the firm of $317,314.25 in 2007 and $165,334 in 2006. When assessing your adjusted average two year income, this income was factored in with other sources of income that were not related to the firm, such as the $47,418 in interest income you reported in 2006.

Ex. 1 at 1-2.

The SBA found that Petitioner was incorrect that Tuck's two-year AGI was $188,729, because it did not include all of Tuck's income in 2007. (Ex. 1 at 1.) The SBA found that, even assuming Petitioner was correct that Tuck's two-year AGI was $188,729, state taxes are not deductible and adding back state taxes paid of $13,532 in 2006 and $23,421 in 2007 would result in an AGI of $225,682. Ex. 1 at 2.

THE APPEAL

Petitioner filed a timely Appeal with the Office of Hearings and Appeals on March 16, 2009. On March 17, 2009, an Administrative Law Judge issued a Notice and Order that required the parties to explore the possibility of settlement and required the SBA to: (1) file a Notice of Appearance by March 26, 2009; (2) file a Response, including its arguments and brief to the Appeal Petition; and (3) serve an authenticated administrative record, including any claims of privilege, by April 30, 2009. The Notice and Order allowed Petitioner fifteen days after service of the authenticated administrative record to file objections.

The SBA submitted its Response and the Administrative Record on April 30, 2009. In its certification of the Administrative Record, the SBA states that "[t]hree documents were withheld in full. These documents are located at Exhibits 2, 2A, 2B, 2C, 6, 6A, and 6B. Exhibit 7 is redacted."[3] The SBA submitted, for in camera inspection, these eight Exhibits which it claims it does not have to provide Petitioner in full because they are covered by the attorney-client and deliberative process privileges. In its Response, the SBA addressed each of Petitioner's five claims.

(1) The SBA did not comply with the language or the spirit of its standard operating procedures (SOP) 80-05 3, Chapter 2D §5(b)(2), "Exclusions from AGI," at 55.

[3] The Certification of Administrative Record and Vaughn Index erroneously states in paragraph three that it is for TMCG and that three documents were withheld in full. The Administrative Record is for Petitioner and seven exhibits were "withheld in full."

The SBA responds that, contrary to Petitioner's assertion, the SBA did deduct federal taxes and Petitioner did not provide evidence that Tuck reinvested in the business any S corporation income she received in 2007. Tuck specifically stated that the amount of $193,309 was a distribution for 2006 that she did not reinvest in the business.

(2) The SBA did not show calculations or explain why it found Tuck's average two-year income to be $267,708 initially and $265,082 on reconsideration.

The SBA responds that the difference in its calculations for 2006 and 2007 is because, on reconsideration, Petitioner provided it with additional information and it corrected a substantial typographical error.

(3) The SBA erred in using the Schedule K-1 distributions and not the figure shown on Tuck's individual tax return, citing *Matter of Tower Communications*, SBA No. 587 (1997);[4] and (4) the SBA deviated from its policy of using the AGI shown on Tuck's individual tax return without any modifications and instead used income from various sources and combined them incorrectly to arrive at an incorrect AGI.

The SBA denies that, as a matter of policy, it relies on only an applicant's AGI as shown on the individual tax return in calculating an applicant's average two-year income. Rather, relying on the regulations at 13 C.F.R. § 124.104(c), the SBA looks to the totality of the circumstances presented by an applicant in its application and extracts all sources of income. The SBA relied here on Tuck's federal tax return and accompanying submission as evidence of income. It is the SBA's position that, absent a regulatory exclusion, it can consider all income from all sources in determining an applicant's personal income.

The SBA cites decided cases to support its position that it is reasonable for it to consider the distributions to Tuck from an S Corporation of which she was one hundred percent owner in determining her income in 2007; that applicants whose AGI is among the top two percent of all taxpayers are not economically disadvantaged; and that its interpretation of how economic disadvantage is determined should be given deference where Congress has not expressed a clear intent on the issue.

(5) The SBA did not conform to the spirit of the SOP in its treatment of federal and state taxes.

The SBA states that, following its regulations and cases decided by the Office of Hearings and Appeals (OHA), it correctly calculated Tuck's average two-year income. Response at 7. The SBA maintains that it "is well settled that all sources of income attributable to the individual claiming disadvantage is considered when determining economic disadvantage" and that its "methodology for determining economic disadvantage is well established and supported by years of OHA precedent." Response at 7.

[4] The SBA included as income $370,807 shown on Petitioner's Schedule K-1 as a distribution to Tuck in 2007.

On May 15, 2009, Petitioner filed Objections to Administrative Record and Claim of Privilege. Petitioner requests that Tuck's Utah State tax returns for 2006 and 2007 be included in the Administrative Record. It claims that the SBA has misrepresented the meaning of its SOP 08-05 3 Chapter 2D, § 5(b) at 54-55. It argues that § 5(b)(1), "Adjusted gross income threshold," directs use of the federal tax return to determine an individual's AGI, and § 5(b)(2), "Exclusions from AGI," excludes from AGI any portion of an individual's income used to pay S corporation taxes. Petitioner claims that it submitted Tuck's State of Utah tax returns for 2006 and 2007 to the SBA and that they were arbitrarily omitted from the Administrative Record.

Petitioner claims that the Administrative Record Exhibits 2, 2A, 2B, 2C, 6, 6A, and 6B are needed to resolve the contradictions and discrepancies in the SBA's position and should not be considered privileged material. Petitioner argues that the SBA was wrong to include in Tuck's two-year average income, a distribution of $370,807 shown on Petitioner's Schedule K-1. Ex. 14 at G.

On June 3, 2009, the SBA filed a Motion to Recall the Administrative Record and for Extension of Time to Respond to Petitioner's Objection to the Administrative Record and SBA's Claim of Privilege (Recall Motion). The Recall Motion notes that the SBA wants to correct an error in the Administrative Record.

On June 4, 2009, the SBA filed an Addendum to its Recall Motion and a Motion to Respond to Petitioner's Objection. The SBA would have me deny Petitioner's request to: (1) add state tax returns to the Administrative Record; and (2) overturn the SBA's claims of privilege on certain material withheld as protected by the attorney-client (Exhibit 2) and deliberative process privileges (Exhibits 2A, 2B, 2C, 6, 6A, and 6B). The SBA argues that the Administrative Law Judge's task is to determine whether the SBA's action in denying the 8(a) application was arbitrary, capricious, or contrary to law based on the evidence in the Administrative Record used to make the determination, and that if the SBA's determination appears reasonable, it must be upheld. The SBA maintains that an Administrative Law Judge may not admit additional evidence unless Petitioner has made a substantial showing, based on credible evidence, that the SBA's determination may have resulted from bad faith or improper behavior. The SBA contends that Petitioner has not submitted evidence that it had submitted state tax returns to the SBA or that the SBA acted in bad faith.

On June 5, 2009, the Administrative Law Judge in separate rulings ordered the Petitioner to file a response to the Recall Motion no later than June 23, 2009, and he deferred resolution of the privilege claims and objections regarding the Administrative Record until the Recall Motion was resolved.

On June 16, 2009, Petitioner filed an Objection to Motion to Recall the Administrative Record. Petitioner argues that, without knowing the substance of the error that the SBA found in the Administrative Record, it cannot know whether changes to the Administrative Record will be prejudicial. Petitioner reiterates that its objections to the SBA's claims of privilege go to what it views as a number of contradictions and misrepresentations between the SBA's denial of the 8(a) application on January 9, 2009, and its denial of reconsideration on January 29, 2009.

On June 18, 2009, the SBA filed a Notice of Appearance and Request for Conference.

Also on June 18, 2009, the Administrative Law Judge issued an Order Denying Motion to Recall. Denial was without prejudice to the SBA filing a motion that specifies why recalling the entire Administrative Record is required.

On June 19, 2009, the SBA filed a Withdrawal of Request for Conference in which it stated that the error in the Administrative Record referred to two pieces of paper from another 8(a) program applicant containing privileged and confidential information that it had mistakenly included in this Administrative Record. According to the SBA, it did not use the material to reach a determination in this proceeding and the Recall Motion was to permit it to remove this material from the Administrative Record.

On July 1, 2009, Petitioner filed Petitioner's Objection to Motion to Respond to Petitioner's Objection to the Administrative Record and the SBA's Claim of Privilege. The basis for the objection is that, as the non-moving party, Petitioner was denied the opportunity to file a response pursuant to 13 C.F.R. § 134.211(c).

RULING ON CLAIMS OF PRIVILEGE

Exhibit 2

Exhibit 2 is a one page memorandum from a senior SBA Counsel in response to a request for a legal review of Petitioner's 8(a) application on reconsideration to an SBA Business Opportunity Specialist (BOS). The SBA contends that Exhibit 2 is protected from disclosure by the attorney-client and deliberative process privileges.

Exhibit 2A

Exhibit 2A consists of five pages, titled BOS Analysis Reconsideration, that has a date of January 23, 2009. It details why the SBA BOS recommended that the 8(a) application be denied. The SBA contends that Exhibit 2A is protected from disclosure by the deliberative process privilege.

Exhibit 2B

Exhibit 2B is a single page spreadsheet showing Tuck's Income in 2006 and 2007 that resulted in an average two-year income of $265,092.13. The SBA contends that Exhibit 2B is protected from disclosure by the deliberative process privilege.

Exhibit 2C

Exhibit 2C consists of two pages from a computer printout, dated April 22, 2009, that identifies five SBA employees who each recommended that the 8(a) application be denied and a draft letter to Petitioner on reconsideration. The SBA contends that Exhibit 2C is protected from disclosure by the deliberative process privilege.

Exhibit 6

Exhibit 6 consists of four pages, titled BOS Analysis Corporation, and has a date of January 8, 2009. It is authored by the same BOS as Exhibit 2A, and the format and conclusion are the same. The SBA contends that Exhibit 6 is protected from disclosure by the deliberative process privilege.

Exhibit 6A

Exhibit 6A consists of a one sentence document titled Chief Certifications Branch and drafted by the same BOS who authored Exhibits 2A and 6. The SBA contends that Exhibit 6A is protected from disclosure by the deliberative process privilege.

Exhibit 6B

Exhibit 6B consists of three pages. The first page is a spreadsheet similar to Exhibit 2B, showing Tuck's income in 2006 and 2007 that resulted in an average two-year income of $267,708.13. The second and third pages are a financial statement analysis. The SBA contends that Exhibit 6B is protected from disclosure by the deliberative process privilege.

Exhibit 7

Exhibit 7 is a single page internal SBA document relative to a criminal history check for certain 8(a) applicants. Exhibit 7 in evidence has only Petitioner's name. The SBA contends that the redacted portions of Exhibit 7 are protected by the deliberative process privilege.

The attorney-client privilege provides the client with the right to refuse to disclose and to prevent others from disclosing confidential communications between the client and the attorney. BLACK'S LAW DICTIONARY 1215 (7th ed. 1999); *Coastal States Gas Corp. v. Dept. of Energy*, 617 F.2d 854, 862 (D.C. Cir. 1980). The deliberative process privilege permits the government to withhold documents relating to policy formulation to encourage open and independent discussion among those who develop government policy. BLACK'S LAW DICTIONARY 1215 (7th ed. 1999); *see In re Grand Jury*, 821 F.2d 946, 958-59 (3d Cir. 1987) (*citing NLRB v. Sears, Roebuck & Co.*, 421 U.S. 132, 150-52 (1975)).

Both of these privileges are applicable to the SBA. Exhibit 2 is an opinion from an SBA attorney on the legality of the SBA's denial of Petitioner's 8(a) application. This type of communication is confidential. As the client, the SBA has a right to claim the advice it received from its attorney about a pending matter is covered by the attorney-client privilege. All the other exhibits are working papers generated by SBA employees to support the SBA's policy decision to deny the application initially and on reconsideration. In addition, Exhibit 7 contains identity information that has no bearing on this application.

Even where a privilege is applicable, it is often relevant to consider the extent of harm non-disclosure causes the party requesting disclosure. *See Upjohn Co. v. United States*, 449 U.S. 383, 396-97 (1981); *In re Sealed Case*, 121 F.3d 729, 737-38 (D.C. Cir. 1997). Non-disclosure does not cause any harm in this situation. The SBA staff findings contained in the privileged

materials were set out by the SBA in support of its determinations. I found nothing in the privileged materials that would provide Petitioner with a new or different factual basis on which to challenge the SBA's decision to deny it eligibility in the 8(a) program. I disagree with Petitioner that it needs copies of Exhibits 2, 2A, 2B, 2C, 6, 6A, and 6B to resolve what it alleges are contradictions and discrepancies in the SBA's position.

REQUEST TO ADD MATERIAL TO THE ADMINISTRATIVE RECORD

I deny Petitioner's request to add copies of Tuck's State of Utah tax returns for 2006 and 2007. Exhibit 4, a submission by Petitioner, indicates that it paid state taxes of $13,532 in 2006 and $23,421 in 2007. The SBA referred to this information in its denial of reconsideration. (Ex. 1 at 2.)

The regulations provide that this type of proceeding shall be decided solely on a review of the written Administrative Record unless there is a credible showing by Petitioner that the SBA's determination may have resulted from bad faith or improper behavior. *See* 13 C.F.R. §§ 134.406, .407(a). There has been no credible showing that the SBA's determination was the result of bad faith or improper behavior. The SBA's recall request was to remove private information that did not belong in this Administrative Record. Initially, the unexplained recall request and the reference to error understandably raised questions, but, now that the reason is known, there is no showing of bad faith or improper behavior.

RULING ON THE SBA'S DECISION TO DENY ELIGIBILITY

To be eligible for the 8(a) program, the SBA requires that the applicant concern must be at least fifty-one percent unconditionally owned and controlled by a socially and economically disadvantaged individual or individuals. *See* 13 C.F.R. § 124.101; Ex. 5. 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 line of business and competitive market who are not socially disadvantaged. *See* 13 C.F.R. § 124.104(a); Ex. 5. The SBA has determined that an individual is not economically disadvantaged if her adjusted average income is in the top two percent of Unites States taxpayers, which at this time was $200,000. Ex. 5.[5] The SBA's Director, Office of Business Development, is authorized to approve or decline applications for admission into the 8(a) program based on information supplied by the applicant. *See* 13 C.F.R. § 124.204(a). Therefore, Petitioner had the burden of proof in establishing eligibility.

The standard for reviewing whether the SBA's denial of 8(a) eligibility was arbitrary, capricious, or contrary to law must be based on the facts contained in the Administrative Record. *See* 13 C.F.R. § 134.406(a). The Supreme Court has set the scope of review of an agency decision under the arbitrary and capricious standard in *Motor Vehicle Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

> The scope of review under the "arbitrary and capricious" standard is narrow and a court is not to substitute its judgment for that of the agency. Nevertheless, the

[5] 2005 was the most recent year for which the SBA had information to perform the calculation.

> agency must examine the relevant data and articulate a satisfactory explanation for its action including a "rational connection between the facts found and the choice made." *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962). In reviewing that explanation, we must "consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment." *Bowman Transportation, Inc. v. Arkansas-Best Freight Systems, Inc., supra,* at 285; *Citizens to Preserve Overton Park v. Volpe*, *supra,* at 416.

As long as the SBA's determination is reasonable, the Administrative Law Judge must uphold it on appeal. *See* 13 C.F.R. § 134.406(b).

The material in the Administrative Record shows that several SBA employees examined the information that Petitioner presented and each one recommended that the application be denied. My review of the calculations shows them to be accurate. I find the SBA's position, that it can consider all income from whatever sources, such as the distributions Tuck received from an S corporation of which she was the sole shareholder, in determining whether Petitioner was economically disadvantaged to be reasonable and supported by precedent. *See TAO of Systems Integration, Inc.,* SBA No. MSB-528 (1995); *Pride Technologies, Inc.*, SBA No. MSB-557 (1996); *Tower Communications,* SBA No. MSB-587 (1997). There is also precedent for a finding that 8(a) applicants whose AGI is among the top percentiles of all taxpayers are not economically disadvantaged. *See Corvus Group, Inc.*, SBA No BDP-184 (2002) (citing *Tower Communications,* SBA No. 587 at 6-7). It is true that courts defer to an agency's interpretation of a statute or regulation where Congress has not expressed a clear intent on an issue. *See Autek Systems Corp. v. United States*, 835 F. Supp. 13, 15 (D.D.C. 1993).

For all the reasons stated, there is nothing in the record that shows that the SBA's determination was arbitrary, capricious, and contrary to law. Accordingly, I deny the appeal. *See* 15 U.S.C. § 637(a)(9)(C); 13 C.F.R. § 134.406(b). Subject to 13 C.F.R. § 134.409(c), this is the final decision of the Small Business Administration. *See* 15 U.S.C. § 637(a)(9)(D); 13 C.F.R. § 134.409(a).

While the case law and high standard for reversal dictate a decision in favor of the SBA, in the future the SBA should provide more detail how it arrived at its AGI figure and its rationale for doing so. In this situation for example, I could not reconcile exactly the difference between the petitioner's AGI on its federal income tax returns and the SBA's AGI calculations because, among other things, the SBA did not specify the amount of federal taxes it deducted from Petitioner's total distributions. Petitioners need an explicit description of SBA's calculations so that they do not repeat the same errors if they chose to submit a new application for admission to the 8(a) program twelve months after the date of the final decision declining an application. 13 C.F.R. § 124.207.

BRENDA P. MURRAY
Administrative Law Judge