

**United States Small Business Administration
Office of Hearings and Appeals**

IN THE MATTER OF:

United Systems of Arkansas, Inc.,

Petitioner,

SBA No. BDPE-593

Decided: August 10, 2021

APPEARANCES

Chasey J. Cox, Esq., Spencer H. Ward, Esq., Newland & Associates, PLLC, Little Rock, Arkansas, for the Petitioner

Mark R. Hagedorn, Esq., Office of General Counsel, U.S. Small Business Administration, Washington, D.C.

DECISION¹

I. Introduction and Jurisdiction

On March 26, 2021, United Systems of Arkansas, Inc. (Petitioner) appealed a decision of the U.S. Small Business Administration (SBA) denying Petitioner entry into SBA's 8(a) Business Development (BD) program. SBA found that Petitioner's owner does not qualify as economically disadvantaged under 13 C.F.R. § 124.104, because his adjusted gross income averaged over the preceding three years exceeds \$350,000. On appeal, Petitioner maintains that SBA improperly calculated adjusted gross income, and that SBA failed take into account a merger between Petitioner and two other concerns owned by the same individual. For the reasons discussed *infra*, the appeal is denied.

SBA's Office of Hearings and Appeals (OHA) decides appeals of 8(a) BD eligibility determinations under 15 U.S.C. §§ 634(i) and 637(a), and 13 C.F.R. parts 124 and 134. Petitioner filed its appeal within 45 calendar days of its receipt of SBA's determination, so the appeal is timely. 13 C.F.R. § 134.404. Accordingly, this matter is properly before OHA for decision.

¹ This decision was originally issued under the confidential treatment provision of 13 C.F.R. § 134.205. After receiving and considering one or more timely requests for redactions, OHA now issues this redacted decision for public release.

II. Background

A. Procedural History

Petitioner initially applied for admission to the 8(a) BD program on April 17, 2020, based on the eligibility of Mr. Robert Bluejacket, Petitioner's sole shareholder and officer. (Administrative Record (AR), Exh. 3.) On February 11, 2021, SBA denied Petitioner's application, finding that Mr. Bluejacket is not economically disadvantaged. (AR, Exh. 1.) SBA explained that an economically disadvantaged individual is a socially disadvantaged individual “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.” (*Id.* at 2, quoting 13 C.F.R. § 124.104(a).) By regulation, an individual is presumed not to be economically disadvantaged if his or her adjusted gross income, averaged over the three preceding years, exceeds \$350,000. (*Id.* at 2-3, citing 13 C.F.R. § 124.104(c).)

To determine average adjusted gross income, SBA generally includes all “applicable personal tax return income line items such as wages, interest, etc.” (*Id.* at 2.) When, however, the applicant is an S corporation, SBA will exclude pass-through income from the applicant in determining the individual's personal income, if the applicant provides documentary evidence demonstrating that the income was reinvested in the firm or was used to pay taxes arising in the normal course of operations of the firm. SBA noted that “[a]ny withdraw of funds from the [applicant] in excess of the amount required to pay the tax on the reported pass through income from [the applicant] is included as personal income to [the individual] along with other income [the individual] received that year as reported on [his or her] personal tax return.” (*Id.* at 3, citing 13 C.F.R. § 124.104(c)(3).)

In the instant case, SBA found that Mr. Bluejacket had adjusted gross income of \$[XXXXXX] during 2017, and \$[XXXXXX] during 2018. (*Id.* at 3, 10.) During 2019, though, Mr. Bluejacket's adjusted gross income rose to \$[XXXXXX]. (*Id.*) As a result, his three-year average adjusted gross income was \$[XXXXXX], an amount which “greatly exceed[s]” the regulatory limit of \$350,000. (*Id.* at 3, 10-11.)

With regard to Mr. Bluejacket's adjusted gross income for 2019, SBA excluded pass-through income that Mr. Bluejacket received from Petitioner itself, because Petitioner retained all its income that year. SBA did not, however, exclude pass-through income from two other concerns also owned by Mr. Bluejacket: Critical Mail Solutions, LLC (CMS) and USA Images, LLC (USAI). (*Id.* at 3.) Although Petitioner urged that SBA also should exclude these distributions from Mr. Bluejacket's 2019 adjusted gross income “because the money was used to pay taxes or was reinvested back in the firm,” SBA found that such an approach would be improper, as the applicable regulations only permit “income received from the applicant firm to be excluded from [adjusted gross income], not income from another firm.” (*Id.* at 11, citing 13 C.F.R. § 124.104.)

B. Appeal

On March 26, 2021, Petitioner filed the instant appeal. Petitioner argues that the determination that Mr. Bluejacket's income exceeds the \$350,000 threshold is “arbitrary,

capricious, and contrary to law.” (Appeal at 2.) According to Petitioner, during 2019, CMS and USAI merged into the applicant firm, Petitioner. SBA failed to fully address Petitioner's evidence of the merger, and did not provide any analysis of that evidence in the denial letter. (*Id.*) Had SBA fully investigated the merger, it would have found that Mr. Bluejacket's income was well below the applicable threshold to be admitted into the 8(a) BD program. (*Id.*)

Petitioner argues, first, that including pass-through income from CMS and USAI in Mr. Bluejacket's income was improper. (*Id.* at 2-3.) Because USAI and CMS were legally merged into one single entity, Petitioner, during 2019, under Arkansas state law, “each constituent organization that merges into the surviving organization ceases to exist as a separate entity.” (*Id.* at 3, quoting Ark. Code Ann. § 4-27-1110.) Petitioner claims that SBA should not have treated the 2019 income from USAI and CMS as separate from Petitioner. (*Id.*) Petitioner explains that the “merger occurred within forty-five days of the date that Mr. Bluejacket executed the documents whereby he purchased his interest in [Petitioner], USAI, and CMS” from the prior owner. (*Id.* at 2-3.) As a result, USAI and CMS ceased to exist as separate entities from Petitioner. (*Id.* at 3.)

Petitioner maintains that “all income for 2019 shown as originating from USAI and CMS should be treated as income from the applicant firm, [Petitioner].” (*Id.*) Any distributions from the merged companies to Mr. Bluejacket therefore should have been treated as “distributions from the applicant firm, and such distributions were used in accordance with the exceptions that are outlined in 13 C.F.R. § 124.104(c)(3)(ii).” (*Id.*) Petitioner observes that SBA properly did exclude pass-through income from Petitioner itself in calculating adjusted gross income for Mr. Bluejacket. (*Id.*)

Next, Petitioner asserts that SBA further erred by failing to exclude all shareholder distributions from Petitioner to Mr. Bluejacket. (*Id.* at 3-4.) Mr. Bluejacket used most of the distributions to pay debt obligations to [Prior Owner], the individual from whom Mr. Bluejacket purchased Petitioner, USAI and CMS. (*Id.* at 4.) As such, Petitioner reasons, SBA should have found that all shareholder distributions, including those from the merged entities, “were reinvested into the applicant firm,” or were used to pay taxes. (*Id.* at 3-4.) Petitioner highlights that the debt Mr. Bluejacket owes on a Promissory Note to [Prior Owner] arises from “the purchase of the ownership interests in [Petitioner], which includes CMS and USAI, as well as licenses and assignments of patents that are integral to the continuance of [Petitioner].” (*Id.* at 4.) According to Petitioner, payments on such debt “should be viewed as income that was reinvested in the applicant firm” because “reinvesting in the business can take many forms, but ultimately relates to the investment in the ownership and operation of the business, which is exactly what Mr. Bluejacket's payments to [Prior Owner] constitute.” (*Id.*) Other than the distributions for taxes and debt payments, Mr. Bluejacket received no additional distributions, and any pass-through income from Petitioner, USAI, and CMS should have been excluded in determining Mr. Bluejacket's income. (*Id.*)

Petitioner maintains that, if USAI and CMS had been considered a single merged entity with Petitioner, and if debt payments to [Prior Owner] had been excluded from Mr. Bluejacket's income, Mr. Bluejacket's 2019 adjusted gross income would have been just \$[XXXXXX], and his three-year average adjusted gross income would have been well below the \$350,000 threshold. (*Id.* at 4-5.) The denial of Petitioner's application should be reversed, and Petitioner should be admitted into the 8(a) BD program. (*Id.* at 5.)

C. SBA's Response

On May 17, 2021, SBA responded to the appeal. SBA maintains that SBA, through its Associate Administrator of Business Development (AA/BD), correctly denied Petitioner's application after concluding that Mr. Bluejacket is not economically disadvantaged within the meaning of SBA regulations. (Response at 4.) As a result, the appeal should be denied. (*Id.*)

SBA first disputes Petitioner's contention that pass-through income that Mr. Bluejacket received from USAI and CMS should have been excluded from the calculation of his personal income for 2019. (*Id.* at 6.) SBA states that it does not contest the validity of the merger of USAI and CMS into Petitioner, which reportedly became effective June 1, 2019. (*Id.* at 7.) However, in accordance with the 8(a) BD program regulations, SBA must examine “an individual's personal income based on his or her ‘[adjusted gross income],’ a term of art defined in the Internal Revenue Code, 26 U.S.C. § 62, and implemented in the IRS Form 1040 (U.S. Individual Income Tax Return), subject to one administrative exclusion pertaining to pass-through income from the 8(a) applicant or Participant.” (*Id.* at 7-8.) In the instant case, SBA excluded the pass-through income that Mr. Bluejacket received from Petitioner itself in calculating his adjusted gross income for 2019 because he did not receive any portion of this income in the form of a shareholder distribution. (*Id.* at 6.) Rather, Petitioner retained all its income in 2019. (*Id.*)

Conversely, SBA did not exclude pass-through income from USAI and CMS in the calculation of Mr. Bluejacket's adjusted gross income. (*Id.*) There is no dispute that, in 2019, Mr. Bluejacket filed “separate Schedule E pass-through income statements for USAI, CMS, and [Petitioner], each identified by its own tax identification number.” (*Id.* at 8; AR, Exh. 4.) Each entity also would have filed its own Schedule K-1 (IRS Form 1065) to report Mr. Bluejacket's respective share of pass-through income. (*Id.*) As a result, it was “reasonable and consistent with SBA regulations for [SBA] to include Mr. Bluejacket's pass-through income from USAI and CMS” to calculate his AGI for 2019. (*Id.*) To do otherwise would have required SBA to depart from information reported on federal income tax returns.

SBA acknowledges that, in the denial decision, the AA/BD did not discuss Petitioner's contention that USAI and CMS were merged into Petitioner, such that the three businesses should be treated as one unified entity. In accordance with OHA case law, though, SBA is “not required to address every argument or assertion made by an applicant in its decline letter” but need only consider “significant evidence and regulations that guide the decision-making process.” (*Id.*, citing *Matter of Unicon, Inc.*, SBA No. BDP-428, at 4 (2012) and *Matter of Bitstreams, Inc.*, SBA No. BDP-122, at 14 (1999).) Regardless of whether Petitioner, USAI, and CMS are treated as one entity under Arkansas state law, this issue would have no bearing on the calculation of adjusted gross income, a determination which is based on the applicable federal tax returns. (*Id.*) Moreover, although not reflected in her decision, the AA/BD nevertheless did consider the 2019 mergers, as demonstrated by pre-decisional analyses which SBA has made available to OHA for *in camera* inspection. (*Id.* at 9.)

Next, SBA contends that the AA/BD also correctly determined that pass-through income used to pay “Mr. Bluejacket's debt obligations to [Prior Owner] do not qualify as reinvestments under 13 C.F.R. § 124.104(c)(3)(ii).” (*Id.*) Ultimately, then, irrespective of whether the AA/BD had treated such distributions as income from Petitioner or as income from USAI and CMS, the

funds do not qualify for exclusion from Mr. Bluejacket's adjusted gross income, because the funds were not utilized for the particular purposes permitted by the regulation. SBA highlights that:

shareholder distributions from an 8(a) applicant that is an S corporation are only excluded where the individual shareholder provides clear documentary evidence that all or part of such funds were either used to pay income taxes from normal business operations or injected back into [the] 8(a) applicant firm as capital.

(*Id.* at 10, citing 13 C.F.R. § 124.104(c)(3)(ii) and 74 Fed. Reg. 55,694, 55,698-99 (Oct. 28, 2009).) Here, by Petitioner's own admission, only \$[XXXXXX] in distributions to Mr. Bluejacket was used to pay state and federal income taxes, whereas \$[XXXXXX] was used to pay his personal debt under the promissory note to [Prior Owner]. (*Id.* at 9, citing AR, Exhs. 3 and 4.) These debt payments are not “reinvestments” because they were not “injected back into [Petitioner] as capital.” (*Id.* at 10.) Further, because Mr. Bluejacket must continue to take shareholder distributions to meet the requirements of the promissory note, the AA/BD reasonably “determined that such income was not unusual or unlikely to occur in the future.” (*Id.* at 7.) Petitioner did not present persuasive evidence to rebut the presumption that Mr. Bluejacket is not economically disadvantaged. (*Id.* at 10-11.)

III. Discussion

A. Standard of Review

An 8(a) BD eligibility determination may be disturbed on appeal only if OHA concludes, based upon the entire administrative record, that SBA's determination was arbitrary, capricious, or contrary to law. *See* 15 U.S.C. § 637(a)(9)(C); 13 C.F.R. § 134.406. OHA's task is to decide whether SBA reached a reasonable conclusion in light of the facts available in the administrative record. 13 C.F.R. § 134.406(b)(2); *Matter of United Global Techs., Inc.*, SBA No. BDPE-518, at 2 (2014). An SBA determination may be found arbitrary and capricious if SBA: (1) fails to properly apply the law and regulations to the facts of the case; (2) fails to consider an important aspect of the problem; (3) offers an explanation for its decision that runs counter to the evidence; or (4) offers an explanation that is so implausible that it cannot be ascribed to a mere difference in view between SBA and OHA. *Matter of MJL Enterprises, LLC*, SBA No. BDPE-566, at 5 (2017); *Matter of McMahon Builders, Inc.*, SBA No. BDPE-461, at 4 (2013).

B. Administrative Record

In conducting its review, OHA may only consider information contained in the written administrative record. 13 C.F.R. § 134.406(a). As a result, the administrative record must be complete before OHA can ascertain whether it supports SBA's determination. *Matter of Southern Aire Contracting, Inc.*, SBA No. BDPE-453, at 2 (2012). A complete administrative record must contain all documents that are relevant to the determination on appeal, and upon which the SBA decision-maker, and those SBA officials that recommended either for or against the decision, relied. 13 C.F.R. § 134.406(c)(1).

In the instant case, SBA filed a comprehensive administrative record with OHA, and Petitioner has not objected to the absence of any documents from the administrative record or to

any SBA claim of privilege. I therefore find that the administrative record is complete. *Id.* § 134.406(c)(3).

C. Economic Disadvantage

To gain entry to the 8(a) BD program, a concern must be unconditionally owned and controlled by one or more socially and economically disadvantaged individuals. 13 C.F.R. § 124.101. An economically disadvantaged individual is a socially disadvantaged individual whose ability to compete in the free enterprise system has been impaired due to diminished capital and credit opportunities as compared with non-socially disadvantaged competitors in the same or similar line of business. 13 C.F.R. § 124.104(a).

In determining economic disadvantage, SBA considers the personal financial condition of the individual claiming disadvantaged status, including income, personal net worth, and the fair market value of all assets. 13 C.F.R. § 124.104(c). SBA will presume that an individual is not economically disadvantaged if his or her adjusted gross income, averaged over the three preceding years, exceeds \$350,000. 13 C.F.R. § 124.104(c)(3)(i). The presumption may be rebutted by a showing that this level of income was unusual and not likely to occur in the future. *Id.* When the applicant is an S corporation, SBA will exclude pass-through income received from the applicant, if the applicant “provides documentary evidence demonstrating that the income was reinvested in the firm or used to pay taxes arising in the normal course of operations of the firm.” 13 C.F.R. § 124.104(c)(3)(ii).

D. Analysis

Having reviewed the record and the arguments of the parties, I see no basis to conclude that the AA/BD's determination was arbitrary, capricious, or contrary to law. As a result, this appeal must be denied.

Petitioner raises two principal arguments in the instant appeal. First, Petitioner maintains that the AA/BD erred by including pass-through income that Mr. Bluejacket received from USAI and CMS in calculating his personal income for 2019. Section II.B, *supra*. Although the AA/BD excluded pass-through income originating from Petitioner itself, SBA did not exclude income from USAI or CMS. It is undisputed that USAI and CMS were merged into Petitioner during 2019, so Petitioner urges that the AA/BD should have treated the three firms as a single unified entity. *Id.* Petitioner points to Arkansas state law to support its contention that USAI and CMS ceased to exist separately after the merger. *Id.*

Petitioner's argument fails because, as SBA emphasizes in its Response and as confirmed by the Administrative Record, Petitioner, USAI, and CMS filed separate Schedule E pass-through income statements during 2019, each with their own tax identification number. Section II.C, *supra*. The applicable regulations instruct that “income received from an applicant or Participant that is an S corporation” may be excluded from the individual's income, but the regulations do not contemplate exclusion of income from concerns other than the 8(a) applicant or participant. 13 C.F.R. § 124.104(c)(3)(ii). Accordingly, based on the tax documents in the Administrative Record, the AA/BD reasonably concluded that pass-through income from USAI and CMS must be included in determining Mr. Bluejacket's personal income.

Moreover, even if the pass-through income from CMS and USAI were considered to have originated from Petitioner itself, the record does not reflect such income was reinvested in Petitioner or used to pay taxes. Rather, a large majority of these funds were used to satisfy Mr. Bluejacket's personal debt obligations on the promissory note owed to [Prior Owner]. Indeed, Petitioner's own accountant informed SBA that \$[XXXXXXX] of the distributions to Mr. Bluejacket were used to "pay taxes to federal, state or local governments related to the income that flows through to his personal return due to [Petitioner] being an S Corporation," whereas \$[XXXXXXX] was used for "[d]ebt payments to previous owner." Section II.C, *supra*. SBA regulations make clear that, in order for income from an S corporation to be excluded from an individual's adjusted gross income, the applicant or participant must come forward with "documentary evidence demonstrating that the income was reinvested in the firm or used to pay taxes arising in the normal course of operations of the firm." 13 C.F.R. § 124.104(c)(3)(ii).

Such evidence is not present here, and Petitioner's arguments to the contrary therefore are meritless. Given the record before her, the AA/BD reasonably found that Mr. Bluejacket's adjusted gross income for the years 2017-2019 exceeded \$350,000. This created a rebuttable presumption that Mr. Bluejacket is not economically disadvantaged. 13 C.F.R. § 124.104(c)(3)(i). Petitioner had the opportunity to overcome this presumption, but the record does not establish that Petitioner actually did so in this case. Although Mr. Bluejacket's personal income was significantly higher in 2019 than in 2017 or 2018, the AA/BD could properly conclude that Mr. Bluejacket likely would need to continue to take large shareholder distributions, in order to satisfy the debt Mr. Bluejacket owed to [Prior Owner].

IV. Conclusion

For the above reasons, I AFFIRM the AA/BD's determination and DENY this appeal. 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).

KENNETH M. HYDE
Administrative Judge

