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## **Introduction**

The Small Business Procurement and Contract Act (**Government Code Sections 14835-14843**) is the statutory authority for small business (SB) certification. The SB certification regulations are contained in the **California Code of Regulations (CCR), Title 2, Subchapter 8, Sections 1896 – 1896.22**.

## **Small Business (SB) Eligibility [GC § 14837(d)(1)(A); 2 CCR 1896.12(a)]**

The small business certification eligibility requirements are as follows:

- The business entity must be independently owned and operated,
- Not dominant in its field of operation,
- The principal office must be in California

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- The officers of the business, in the case of a corporation; officers and/or managers, or in the absence of officers and/or managers, all members in the case of a limited liability company; or the owner(s) in all other cases, must be domiciled in California, and,
- Together with affiliates:
  - Has 100 or fewer employees, and an average gross annual receipts of \$15 million or less over the previous 3 tax years (All other business types except Manufacturer), or
  - A manufacturer with 100 or fewer employees **[GC § 14837(c)(1) & (2)]**.

### A Small Business for the purpose of Public Works Contracts (SB-PW)

**[GC § 14837(d)(1)(B); 2 CCR 1896.13] meets:**

- The general qualifying criteria for Small Business certification, and in addition:
  - Has 200 or fewer employees, and an average gross annual receipts of \$36 million or less over the previous 3 tax years
  - The manufacturer industry type has the same GARs and employee count requirement as the other industry types. There is no special requirement.

### Microbusiness Eligibility **[GC § 14837(d)(2); 2 CCR 1896.12(b)]**

“Microbusiness” (MB) is a small business that, together with affiliates:

- Has average annual gross receipts of \$5 million or less over the previous three tax years, or
- It is a manufacturer with 25 or fewer employees.

MBs do not receive a separate certification. They are a subset of the SB category. The MB designation is automatically assigned by the system.

### Difference between SB and SB-PW certification

	SB	SB-PW
GARs cap (averaged over 3 years)	\$15,000,000	\$36,000,000
Maximum employee count (based on recent 4 quarters)	100	200
Include GAR limit for manufacturers?	No	Yes
Does it have a Microbusiness (MB) designation?	Yes	No
Get SB credit for what type of contracts?	All state contracts*	Limited to public works-related state contracts/projects**

\*SB certification can be used and counted on all types of contracts including public works contracts and/or projects.

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\*\*SB-PW certification can only be counted toward SB participation on public works-related contracts/projects.

### **Independently Owned and Operated**

For purposes of small business certification, SB regulations [2 CCR § 1896.12(d)(7)] defines “independently owned and operated” as:

*“...a business entity whose ownership interests, management and operation are not subject to control, restriction, modification or limitation by an outside source, individual or another business entity.”*

“Control” means having the power and authority to direct the overall and/or the day-to-day operations of the applicant business [2 CCR § 1896.4(i)].

### **Determining Ownership and Operational Independence**

2 CCR § 1896.12(d)(7) establishes the determination of whether the applicant business is *not independently owned and operated* if the following exists:

- An outside person or business concern owns or controls, or has the power to control, fifty percent (50%) or more of the voting stock of the applicant business, or
- One or more business owners, general partners, directors, officers or members of an outside business concern controls or have the power to control or influence the day-to-day operations of the applicant business, board of directors and/or owner(s) of the applicant business.

#### **Example #1: 50% stock or more:**

President/Secretary: John Doe owns 50%. Treasurer: Mary Doe owns 30%. Vice President: Jill Doe owns 20%. John Doe is considered to have the power to control the business.

#### **Example #2: Less than 50% stock:**

President/Secretary: John Doe owns 40%. Treasurer: Mary Doe owns 30%. Vice President: Jane Doe owns 20%. Secretary: Jack Doe owns 10%. John Doe is considered to have the power to control the business.

#### **Example #3: Two or more parties with less than 50% stock:**

President/Secretary: John Doe owns 42%. Vice President: Jill Doe owns 40%. Treasurer: Mary Doe owns 10%. Secretary: Jim Doe owns 8%. John Doe and Jill Doe are presumed to have the power to control the business.

Two or more parties are presumed to control, or have the power to control less than 50% of the voting stock of an applicant business concern when:

- Each of their blocks of stock is equal or substantially equal in size, **and**
- Is large as compared with any other block(s) outstanding.

#### **Example #4: Person(s) with control of more than one business concern:**

John Doe is all officers and owns 100% of XYZ, Inc. (applicant firm), and is the sole owner and manager of XYZ, LLC (other firm) which owns the corporation. John Doe has the power to control the applicant firm because: a) he is the sole owner of the applicant and b) sole owner of the LLC which is a holding company. The management of both firms mirrors each other since he is the only officer of the corporation and the only manager of the LLC.

There is no outside entity when the same owner has the power to control more than one business and the outside entity is a holding company. Therefore, the applicant firm is

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deemed independently owned and operated. The “other firm” is identified as an affiliate. See affiliation section.

### Subsidiaries

Subsidiaries by definition are not independently owned and operated. A subsidiary, in business matters, is an entity that is controlled by a bigger and more powerful entity.

- The controlled entity is called a company, corporation, or limited liability company and in some cases can be a government or state-owned enterprise, and the controlling entity is called its parent (or the parent company). The reason for this distinction is that a lone company cannot be a subsidiary of any organization; only an entity representing a legal fiction as a separate entity can be a subsidiary. While individuals have the capacity to act on their own initiative, a business entity can only act through its directors, officers and employees.
- The most common way that control of a subsidiary is achieved is through the ownership of shares in the subsidiary by the parent entity. These shares give the parent the necessary votes to determine the composition of the board of the subsidiary and so exercise control. This gives rise to the common presumption that 50% plus one share is enough to create a subsidiary.
- There are, however, other ways that control can come about and the exact rules both as to what control is needed and how it is achieved can be complex (see below). A subsidiary may itself have subsidiaries, and these, in turn, may have subsidiaries of their own. A parent and all its subsidiaries together are called a group, although this term can also apply to cooperating companies and their subsidiaries with varying degrees of shared ownership.
- Subsidiaries are separate, distinct legal entities for the purposes of taxation and regulation. For this reason, they differ from divisions, which are businesses fully integrated within the main company, and not legally or otherwise distinct from it.

### Trusts

Trusts are not considered a “business entity” and therefore trusts can “own” the applicant firm and the applicant firm is still considered to be independently owned and operated.

- If the applicant firm is wholly held within a trust or more than one trust, a copy of the trust or trusts must be provided. This is to confirm the ownership, management of the applicant firm and how the trust impacts business operations.
- Factors in determining if the trust is required is the percentage owned by the trust and if any businesses held within a trust could rise to the level of an affiliate and/or as determined by **2 CCR § 1896.12(d)(6)**. In most cases, if the same trust owns multiple businesses in addition to the applicant, those other businesses will be considered affiliates.
- Note: you may obtain trust documentation that contains limited information on assets or lacks validated existence of affiliate(s). Refer to the personal federal tax returns (FTRs) of the owners/officers who hold the trust. Compare the personal FTRs against the applicant firm’s corporate FTRs. Review the corporate K-1 and the owners/officers Schedule E (which reflects income, positive or negative). The totals should agree.

### Employee Stock Ownership Plan (ESOP)

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An employee stock ownership plan (ESOP) is a retirement plan in which the company contributes its stock (or money to buy its stock) to the plan for the benefit of the company's employees. By far the most common form of employee ownership in the U.S. is the ESOP. The plan maintains an account for each participating employee. Shares of stock vest over time before an employee is entitled to them. With an ESOP, buying or holding stock directly while still employed with the company does not take place. ESOPs are most commonly used to provide a market for the shares of departing owners of successful closely held companies, to motivate and reward employees, or to take advantage of incentives to borrow money for acquiring new assets in pretax dollars. In almost every case, ESOPs are a contribution to the employee, not an employee purchase.

Shares in the trust are allocated to individual employee accounts. Although there are some exceptions, generally all full-time employees over 21 participate in the plan. Allocations are made either on the basis of relative pay or some more equal formula. As employees accumulate seniority with the company, they acquire an increasing right to the shares in their account, a process known as vesting. Employees must be 100% vested within three to six years, depending on whether vesting is all at once (cliff vesting) or gradual.

When employees leave the company, they receive their stock, which the company must buy back from them at its fair market value (unless there is a public market for the shares). Private companies must have an annual outside valuation to determine the price of their shares. In private companies, employees must be able to vote their allocated shares on major issues, such as closing or relocating, but the company can choose whether to pass through voting rights (such as for the board of directors) on other issues. In public companies, employees must be able to vote all issues.

### Processing Small Businesses with ESOP Ownership

Request the following:

- ESOP agreement
- List of employees who are in the ESOP
- Home addresses of ESOP participants
- Current percentage of shares allocated to each participant employee

### Holding Company

When a "holding company" owns the applicant firm, the applicant is considered to be independently owned and operated as long as the holding company's owners/officers mirror that of the applicant firm.

- A holding company is a company that owns other companies' outstanding stock. It usually refers to a company which does not produce goods or services itself, rather its *only* purpose is to own shares of other companies.
- Holding companies allow the reduction of risk for the owners and can allow the ownership and control of a number of different companies.
- Note: Sometimes a company intended to be a pure holding company identifies itself as such by adding "Holdings" or "(Holdings)" to its name, as in Sears Holdings.

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## Principal Office

OSDS's determination of whether the principal office of a business is located in California, as Government Code § 14837(d)(1) mandates, shall be based on, but not limited to, a review of the address or physical location where management, direction and control of operations originate [2 CCR § 1896.12(d)(5)].

## Domicile

In small business certification, the officers of a business in the case of a corporation, managers or members in the case of a limited liability company; or the owners in all other cases must be domiciled in California.

Entity Type	Who needs to be domiciled in CA
Sole Proprietorship	Owner
General Partnership	All Full or General Partners
Limited Partnership	General Partners
Corporation	Officers
Limited Liability Company	Managers/ Members/Officers Depending on the management of the business

### Domicile: According to the IRS:

A person has only one domicile even if they have more than one home. A person's domicile is a permanent legal home that they intend to use for an indefinite or unlimited period, and to which, when absent, they intend to return. A person must be able to show with facts that they intend a given place or state to be their permanent home. If a person moves into or out of a community property state during the year, they may or may not have community income. According to regulations [2 CCR § 1896.12(d)(4)], the Department's determination of person's domicile may be based on the following:

- Voter's registration records;
- Homeowner's property tax filings;
- Driver's licenses;
- Utility bills;
- Individual state tax returns; and
- Other documentation indicating presence in California is more than temporary or transient.

### Amount of time spent - According to the IRS:

- The amount of time spent in one place does not always explain the difference between home and domicile. A temporary home or residence may continue for months or years while a domicile may be established the first moment you occupy the property.

## Dominant [2 CCR § 1896.12(d)(8)]

A business that exercises or has the ability to exercise a controlling or major influence, on a statewide basis, in a kind of business activity or field of operation in which a number of business concerns are primarily engaged, shall be determined to be dominant in its

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field of operation. The following criteria may be considered in determining if the business is dominant in its field of operation:

- Volume of business
- Financial resources
- Competitive status or position
- Ownership or control of materials, processes, licenses or agreements and facilities
- Sales territory and nature of business activity

A firm that is dominant in its field of operation(s) is not eligible for certification.

### **Number of Employees [2 CCR §1896.12 and 1896.13]**

The number of employees for small business, microbusiness and small business for the purpose of public works certification must not exceed specific statutory limitations. Use the California Employment Development Department's Quarterly Contribution Return and Report of Wages (Continuation) (DE 9C) or other format accepted by EDD or reported as an employee by the business on another state's report equivalent to confirm employee totals. This will include an evaluation of out-of-country employee information. Subdivision (l) of 2 CCR § 1896.4 is a formal regulatory definition of "employee."

- Professional Employer Organizations (PEO) are firms that provide a service by which an employer can outsource employee management tasks, such as employee benefits, payroll, workers' compensation, recruiting, risk/safety management, and/or training and development. The PEO becomes the **employer of record** for tax and insurance purposes, but the business maintains complete control over employees' day-to-day work and job description, as well as, its management and organizational structure.
- When a firm contracts a PEO, the firm does the hiring and firing of its employees. A copy of the PEO agreement and PEO records to document the firm's employee count for the four most recent quarters must be provided. In some instances, the PEO can provide the DE 9C form for each quarter.

### **Calculating Number of Employees**

The number of employees is calculated by combining the number of employees for each of the 12 months in the four most recent quarters on the applicant's (and/or affiliate's) DE 9Cs and dividing by 12 to come up with an average.

- In some cases, firms will submit an EDD 941 quarterly report. Add the four quarters and divide by four.
- If the applicant or affiliate has had employees for less than a year, divide the total number of employees by the number of months or quarters.

**Note:** In cases where an applicant did not submit all four quarters of the DE9C form and it is the only issue that prevents a certification officer from approving the certification, the determination that the applicant firm does meet the statutory employee requirement can be confirmed based on the following:

- The submitted DE9C forms reflect an average 25 or less employees.
- The applicant firm has no affiliate(s).
- Previously, the employee count has been less than 25 employees (if applicable).



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- The Gross Annual Receipts are relatively low.
- Salaries and Wages on business federal tax returns are relatively low (if applicable).
- Cost of Labor on business federal tax returns are relatively low (if applicable).
- Employee count can be verified in any other business support documents.

If the employee count can be verified using the criteria above, the applicant firm should not be denied certification because all four quarters of DE9Cs were not submitted.

\*\*The above employee count criteria can be applied in cases where one affiliate firm did not provide all four quarters of DE9Cs.

It is important to analyze the employee information to determine an accurate certification decision. If the employee counts for the applicant or an affiliate firm can be verified using the criteria above, the applicant firm should not be denied certification because all four quarters of DE9Cs were not provided.

If unsure, consult with your manager.

### **Gross Annual Receipts (GARS) [2 CCR §§ 1896.4(m)]**

A small business' (SB) gross annual receipts (GARs) (including its affiliate GARs) must not exceed the statutorily specified amounts for SB, MB or SBPW as documented over a previous three tax year period. Because applicant tax returns are analyzed to determine GARs, individuals and businesses seeking certification are obligated to submit copies of their tax filings in accordance with **2 CCR § 1896.12(d)**. This enables OSDS to consider organizational structure, operations and business relationships during the previous three tax years in determining certification eligibility.

- To determine if the applicant meets the GARs requirement, review the federal income tax returns covering the current three-year period. If the applicant firm has been in business less than three years, the tax returns for the number of years the firm has been in business is required. If the applicant firm has an affiliate, the same requirements as indicated in the aforementioned apply.
- A tax year or fiscal year is the accounting period used for keeping records and reporting income and expenses. For those businesses whose fiscal year is other than a calendar year (January 1 through December 31), their tax year is the year the tax period began.

#### Example

During the 2011 tax year, the OSDS GARs review required completed tax periods 2010, 2009, and 2008. The corporation's fiscal year is July 1 through June 30.

This table provides the appropriate tax period submission.

<b>Tax Year</b>	<b>Tax Period</b>
2010	July 1, 2010 through June 30, 2011
2009	July 1, 2009 through June 30, 2010



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2008	July 1, 2008 through June 30, 2009
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This table provides an *incorrect* tax period submission.

Tax Year	Tax Period
2010	July 1, 2009 through June 30, 2010
2009	July 1, 2008 through June 30, 2009
2008	July 1, 2007 through June 30, 2008

It is important that the firm's business income is accounted for by number of years the firm has been in business. For a firm that has been in business for three years or more, 36 months of income must be accounted for. If a firm has changed from a fiscal year to a calendar year, the calculation must be pro-rated.

### Example

The firm has submitted the following tax returns identifying that their tax year is changing to a calendar year.

Tax Year	Tax Period	GARS
2010	July 1, 2010 through December 31, 2010	20,000
2009	July 1, 2009 through June 30, 2010	40,000
2008	July 1, 2008 through June 30, 2009	41,000
2007	July 1, 2007 through June 30, 2008	42,000

In this example, the amount must be pro-rated to account for 36 months. The income for 2010 is only for six months. Six months of 2007 income must be added. Divide the gross income for each year by 12 to get a monthly income and times the amount by six. Adjusted GARS would be as follows: 2010- 39,800 (20,000 + 19,800), 2009- 40,200 (19,800 + 20,400) and 2008 (20,400 + 21,000) = 41,400.

### **Federal Income Tax Return (FTR) Ownership Form Types**

The FTR is the most important support document used in the certification review process. The applicant must submit the entire FTR when requested. Each ownership type must submit a specific FTR form number as follows:

Ownership	Tax Form
Sole proprietorship	1040, Schedule C
Partnership	1065
Corporation	1120, 1120-A or 1120S
Limited Liability Company (LLC)	1040, 1065, 1120, 1120-A or 1120S
Limited Liability Partnership (LLP)	1065
Joint Venture	1065 (plus further research)

### **Federal Income Tax Return (FTR) Line Items for GARS**

The complete FTR and all supporting tax schedules and forms are required. The specific tax return line items used to calculate gross annual receipts (GARS) of the applicant firm and their affiliates, if any affiliates are identified.

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Ownership Type	FTR	Line items utilized
Sole Proprietorship	1040	Schedule C, Line 3; Review for Multiple Schedule C and Schedule E for possible affiliates.
Partnership	1065 (Partners' FTRs, not required).	Page 1, Line 1c
Corporation	1120, 1120S (Shareholder & Officer FTRs, not required) 8825	All forms: Page 1, Line 1c Line 17
Limited Liability Company – LLC (filing as a sole- proprietorship)	1040	Schedule C, Line 3; Schedule E: review for possible affiliates.
Limited Liability Company – LLC (filing as a partnership)	1065 (LLC members' FTRs, not required).	Page 1, Line 1c
Limited Liability Company – LLC (filing as a corporation)	1120, 1120A, 1120S. (Owners and Officer 1040s, not required) 8825	All forms: Page 1, Line 1c 8825: Line 17
Limited Liability Partnership – LLC	1065 (LLP members' FTRs, not required)	Page 1, Line 1c

### Federal Income Tax Return (FTR) – Rental or Lease Business

If an entity's primary purpose is conducted for income or profit and they're involved in a rental activity with continuity and regularity, the rental activity is a business.

Examples:

- A real estate professional who receives income from renting real property.
- A hotel or motel owner who provides services (i.e., housekeeping services)
- Renting personal property, i.e., equipment, vehicles, formal wear, etc.

### IRS forms by ownership type

- Sole proprietorships report their rental "business" activity on a Schedule C.
- Partnerships and S-Corporations report their rental or leasing activities on a Form 8825.
- C-Corporations report their rental activity on their Form 1120, line 6.

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### Federal Income Tax Return (FTR) Extensions

A valid tax filing extension is required when the applicant firm's most recent tax return has not been filed with the IRS. If an applicant's initial tax filing extension expires and a second tax filing extension is granted, a copy of the second tax filing extension must be submitted.

### Federal Tax Return Due Dates

	IRS Form 1120		IRS Forms 1065 and 1040	
Tax Year End	2.5 months from Tax Year End	After a 6 Month Extension	3.5 months from Tax Year End	1065 After 5-mos 1040 After 6-mos Extension
<b>December 31</b>	<b>3/15</b>	<b>9/15</b>	<b>4/15</b>	<b>10/15</b>
January 31	4/15	10/15		
February 29	5/15	11/15		
March 31	6/15	12/15		
April 30	7/15	1/15		
May 31	8/15	2/15		
June 30	9/15	3/15		
July 31	10/15	4/15		
August 31	11/15	5/15		
September 30	12/15	6/15		
October 31	1/15	7/15		
November 30	2/15	8/15		

- Corporations file returns by the 15th day of the third month after the close of their tax year. Corporations using a calendar year file by March 15.
- Partnerships file returns by the 15th day of the fourth month after the close of their tax year. Most partnerships use a calendar year and file returns by April 15. Some partnerships use a fiscal year.
- Sole proprietors file returns by April 15. Sole proprietorships with a 6-month extension file by October 15.

**Limited Liability Company (LLCs)** are "disregarded as an entity" by the IRS. Meaning it is not recognized for tax purposes as an **entity** separate from its owner, if the LLC has a single manager/member, the manager/member will report to the IRS on Form 1040 or may elect to use Form 1120. If the LLC has more than one manager/member, the managers/ members will report on Form 1065 or on Form 1120.

### Certification Eligibility Factors

Use the SB Checklist to determine eligibility. A certification determination is based on numerous factors, including:

- Industry type
- Ownership type
- Does applicant meet specific SB or SB-PW eligibility criteria?
- Affiliate relationships (for SBs and SB-PWs)
- When applicable, were the appropriate support documents submitted?

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- Do the documents support the business' structure and functions and program requirements?
- Is the firm independently owned and operated (IOO)?
- Is there enough to make a final determination?
- If not, more information must be obtained from the applicant.

If an approval or denial is determined, all actions and documentation must be in compliance with statute and regulations.

**\*Note:** When a firm is SB certified, the microbusiness designation will be auto-generated by the system if the firm meets specific requirements. SB-PW certification does not have a microbusiness designation.

### Industry (Business) Types

Industry types are general industry classifications. We use the following:

- Service – Any business that performs certain duties. Services does not include sales and manufacturing. Examples: consulting, rental, janitorial services, etc.
- Construction – Any business issued a valid California contractor's license. Licensed contractors are not allowed to perform land surveying and civil engineering work. When licensed contractors work outside of their specific classification or scope of work, they subject their license to possible criminal charges from Board for Professional Engineers, Surveyors and Geologists (PELSG) and disciplinary action from CSLB.
- Non-manufacturer – Any business which sells products and has a valid seller's permit issued by the Department of Tax and Fee Administration.
- Manufacturer [GC § 14837(c)(1) & (2)]

For an applicant to receive manufacturer designation, the Government Code requires that the applicant firm meet specific criteria. Per **[2 CCR § 1896.12(d)(3)]** They must:

- Be primarily engaged in the chemical or mechanical transformation of raw materials or processed substances into new products
- The end item must possess characteristics that, as a result of mechanical, chemical, or human action, it did not possess before the original substances, parts or components were assembled or transformed.
- The end item may be finished and ready for utilization or consumption, or it may be semi-finished as a raw material to be used in further manufacturing.
- Be classified between North American Industry Classification System (NAICS) codes 31 to 33.

Other consideration factors include:

- Does the applicant use their own facilities to manufacture their products?
- Does their website identify the firm as a manufacturer?
- Does 50% or more of their gross annual receipts (GARs) come from the sale of products manufactured by the business?
- Does the tax return identify their business activity and/or code as manufacturing?
- Do the tax return statements reflect depreciation of equipment?

Certification does not require an applicant to be classified in an industry type. However,

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an industry type description is important to the certification process because it:

- Sets the review path for certification officers
- Aids online query users when searching for firms within a specific industry.

**Note:** If the firm does not meet the requirement for a specific industry type, determine if the firm is eligible to be classified in another industry type. Review each industry type individually and if the firm has not applied for that type, discuss your findings with the firm to certify the applicant in that industry type. Example: applicant applied for "Construction" without a valid contractor's license, but can be certified as a "Service". Let the firm know and receive written permission to add that industry type. Do not just deny their request for certification in "Construction".

### Ownership Types

An ownership type is any of the following:

Type	Definition	Certification consideration
Sole Proprietorship	The business' sole owner holds exclusive rights over the firm	One owner or husband/wife
Partnership	Shared business ownership with another or others, and established by a written agreement	Must have at least two partners
Corporation	A legally established association that exists as an entity with powers and liabilities independent of those of its officers/shareholders	Must account for President, Vice president, Secretary, and Treasurer/Chief Financial Officer
Limited Liability Company (LLC)	Members/Managers are afforded a combination of corporate limited liability and partnership pass-through tax advantages without restrictions imposed on limited partnerships and subchapter S corporations	<ul style="list-style-type: none"> <li>• Can be a single member/manager filing 1040 or 1120</li> <li>• If multi-member/manager, can file 1065 or 1120</li> </ul>
Limited Liability Partnership (LLP)	Limited liability partnerships may only be formed by licensed persons for the practices of public accountancy, law or architecture	<ul style="list-style-type: none"> <li>• See definition requirements</li> <li>• Files 1065</li> </ul>
Joint Venture	A business association established to engage in and carry out a business venture for joint profit, for which purpose they combine their efforts, property, money, skills, and/or knowledge.	See "Joint Venture"
Nonprofit	A legally established association established to engage in and carry out not for profit business activities	See "Nonprofit"

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A certified small business contractor, subcontractor or supplier of goods and/or of services that contributes to the fulfillment of contract requirements shall perform a CUF for each contract [2 CCR 1896.15(a)]. The “commercially useful function” requirement is intended to counteract brokering or pass-through activity for the purposes of giving the appearance of small business or DVBE participation. CUF affirms that the intended or named small business or DVBE will perform substantive activities in fulfillment of a State contract or purchasing transaction. The contracting or purchasing officials of awarding departments must determine CUF performance for the specific contract or purchase [2 CCR 1896.15(d)].

2 CCR 1896.15(b) describes commercially useful function (CUF) as the performance of:

- The contractor or subcontractor is responsible for the execution of a distinct element of the work of the contract (including the supplying of services and goods); carrying out its obligation by actually performing, managing or supervising the work involved; and performing work that is normal for its business services and functions; and
- The contractor or subcontractor is not further subcontracting a greater portion of the work than would be expected by normal industry practices.
- The contractor or subcontractor is responsible, with respect to products, inventories, materials and supplies provided on the contract, for negotiating price, determining quality and quantity, ordering the material, installing (when applicable), and paying for the material itself.
- A contractor or subcontractor will not be considered as performing a commercially useful function if its role is limited to that of an extra participant in a transaction, contract, or project through which funds are passed in order to achieve the appearance of small business participation.

### Additional Required Support Documents

In addition to the minimum required support documents an SB and SB-PW applicant may also be required to submit:

#### Limited Liability Company (LLC)

- The applicant’s current Articles of Organization as filed with the California Secretary of State.
- The applicant’s most recent “Statement of Information” as filed with the California Secretary of State listing the manager (s) and/or member (s). If not on file, do not accept one that is marked “No Change”.
- The applicant’s current Operating Agreement. (Smaller LLCs may not have an operating agreement. Supervisory approval to omit this document is required.)

#### Corporation

- The corporate meeting minutes showing the most recent election of all current corporate officers and director, **or**
- The last “Statement of Information” (as filed with the California Secretary of State) that lists the current corporate officers.

#### Joint Ventures [2 CCR §1896.12(c)]

- Each co-venturer must be certified as a Small Business.
- Provide a copy of the Joint Venture agreement.

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- Not subject to average annual gross receipts and employee limits.

### Other Support Documents

It's not unusual to require the following documents to support certification eligibility:

- Seller's permit for non-manufacturers
  - California Department of Tax and Fee Administration (CDTFA) website [www.cdtfa.ca.gov](http://www.cdtfa.ca.gov)
  - Check or confirm validity and current status of Seller's Permit
- Licenses and permits for all business types
- Contractor's State License Board (CSLB) website- [www.cslb.ca.gov](http://www.cslb.ca.gov)
  - Check status of CSLB license
- Written agreements between the applicant and other business(es)
- Sales agreement
- Trusts
- Partnership agreement

### Affidavit of Income (AI) [2 CCR § 1896.12(d)]

When conducting a Small Business (SB) certification review, law and regulation requires evaluation of the Gross Annual Receipts (GARs) and this is documented on the Federal tax returns (FTRs) for the three most recently completed tax years for the applicant and affiliates. If the applicant has been in business, if less than three years, they must provide the tax returns for the years they have been in business.

- In accordance with the **2 CCR § 1896.12** authorization to request other documentation deemed necessary for OSDs to make a final certification determination, an applicant may use an Affidavit of Income (AI) (Rev. 11/4/2016) as a temporary proof of annual receipts submittal, only when the required FTR(s) for the most recently completed tax year has not yet been filed.
- A copy of the hardcopy FTR(s) must replace the AI for the applicant and each affiliate within the following timeframes (whichever occurs first):
  - Within 90 days of certification, or
  - Within two weeks of a tax filing extension's expiration (when granted by IRS), or
  - When the FTR is filed with the Internal Revenue Service (IRS)

Non-compliance may result in the denial of the firm's certification, or discontinuance of the certification of a currently certified entity.

### Affidavit of Income (AI) Submission Requirements

Use the SB FTRs to evaluate gross annual receipts (GARs) and affiliation. Therefore, an SB applicant must complete the Small Business section (B) of the AI, which provides applicant and affiliate GARs information.

When a small business applicant or affiliate has not filed tax returns with the IRS, the following must occur:



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If the tax filing due date has...	Then the applicant should submit:
Not yet passed	An <a href="#">Affidavit of Income (Rev. 11/4/2016)</a> completing Sections A, B, and D, <b>and</b> An audited or unaudited Business Income Statement if the gross annual receipts average \$12.5 million or more over the three previous tax years for the applicant and each affiliate
Passed	Same as above and a copy of the tax filing extension for the applicant and each affiliate

### **Affiliation** [See also: Standing Protocol: “Affiliates”]

OSDS’s determination of whether a business is affiliated with another, with respect to satisfying GC §14837(d) requirements of “independent ownership and operation” may be based on, but not limited to, historical and current factors including ownership, management, financial and/or business relationships or ties with another business, such as familial relationships, contractual relationships, assignments, passage of title to goods or merchandise, and other related matters as reflected in tax returns and other documentation [2 CCR § 1896.12(d)(6)].

- Whether two business are **affiliated** is based on historical and current factors during the previous three tax years.
- Affiliate or affiliation is defined as: “...a relationship of direct or indirect control or shared interests, as determined in §1896.12(d)(6), between the applicant or a small business and another business [2 CCR § 1896.4(a)].”
- A joint venture is deemed an affiliate for certification purposes [2 CCR § 1896.12(d)(6)(C)]

OSDS may consider the following in determining affiliation:

- The applicant business assigns a contract, in whole or in part, to another business;
- There exists common ownership and/or management with the applicant business and another business;
- The applicant business and another business share facilities, equipment, systems or employees;
- There is a familial relationship with the applicant business and another business and both are in the same industry; A person or business has assisted the applicant business with activity to meet bond/security requirements.

The following types of business relationships shall not be considered affiliations:

- A franchise and/or license agreement provided that the franchisee or licensee has the right to profit from its efforts and bears the risk of loss commensurate with ownership;
- A manufacturer’s or service provider’s representative provided that a written

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agreement exists between the manufacturer(s) or service provider(s) and the representative that substantiates the independent nature of the individual businesses.

### Familial Relationships

Relationships between the following family members, but not limited to: husband, wife, child, stepchild, sibling, mother, father, grandparent, grandchild, stepbrother, stepsister, stepmother, stepfather, mother-in-law, father-in-law, brother-in-law, sister-in-law, daughter-in-law, son-in-law, aunt, uncle, niece, or nephew.

### Control

Means having the power and authority to direct the overall destiny and/or day-to-day operations of the business [2 CCR § 1896.4(i)]. Suspicions about ownership independence arise when there are questions about or evidence of:

- Ownership by individuals other than the applicant,
- Management by individuals other than the applicant, Financial and/or business relationships or ties with another business, such as Contractual relationships, Assignments or the Passage of title to goods or merchandise, and other related matters,
- The applicant business assigns a contract, in whole or in part, to another business,
- There appears to be common management between the applicant and another business,
- Shared facilities, equipment, systems, or employees between the applicant and another business,
- A familial relationship between the applicant and another business and both businesses are in the same industry,
- A person or business has assisted the applicant with activity to meet bond/security requirements.

### Affiliation Determination Protocols [See also Standing Protocol: “Affiliates”]

The protocols for determining small business affiliation is to:

- Establish a relationship based on *control* or *shared interests* between the applicant and another business(es) using the “Affiliation Chart.”
- Analyze business activity information contained in the applicant’s certification application, the “Affiliate Information Form”, and support documents.

The following circumstance presume an affiliation exists; however, such presumption may be rebutted by clear and convincing evidence that an affiliation does not, in fact, exist:

- The applicant is assisted by another business concern,
  - Which is engaged in a similar or commonly related business activity, to meet bonding or other security requirements, **and**
  - The assisting business concern is listed or otherwise designated as a subcontractor or supplier for more than 40% of the contract price required to be performed per the prime bid.
- If the controlling or majority owners of concerns which are engaged in similar or commonly related business activity have ***familial*** relations by blood or marriage

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(husband, wife, father, mother, child, sibling, grandparent, grandchild, step-parent, step-sibling, mother and father-in-law, aunt, uncle, and cousin), **and**

- Have established a business or financial relationship between them.
- If 70% or more of the annual receipts for a business concern's preceding fiscal year are derived from the sale, lease, or rental of goods supplied by a single manufacturer or supplier **and** such goods have been acquired by said business concern for:
  - More accommodating terms and conditions than generally offered by the manufacturer or supplier to other customers; **or**
  - A lesser price than generally offered by the manufacturer or supplier to other customers.

### **Affiliation: Agent/Broker Relationships**

Applicants involved in an agent/broker relationship will be considered an affiliation when the factors below exist.

- A commissioned representative in business for one large company versus multiple companies (Travel agencies, real estate agents and insurance agents are excluded when they serve multiple companies).
- When the applicant business is unable to transfer title to the goods being delivered.
- A firm that acts as an agent for a manufacturer or supplier, and transacts business with the same manufacturer or supplier for the same products on a non-agent basis, is a conclusive presumption that the concerns are affiliated.

Note: A written agreement between the applicant and the other business must show the independent nature of the individual businesses.

### **Affiliation: Employees of Employers**

An affiliation exists when an employee sells their employer's products through their own business. This scenario can include the secondary affiliation factors such as shared employees, contractual agreement, shared facilities, and possibly financial relationship.

### **Affiliation: Sole Proprietorships (Form 1040) with Multiple Schedule Cs**

When determining affiliation for sole proprietorships with multiple Schedule C's, you must consider all affiliation factors. Refer to the Affiliation Chart.

- How to Identify Multiple Schedule Cs: Form 1040, Line 12, should reflect the sum total of all Schedule C, Line 31 for affiliates. If they do not match, notify the applicant to provide the entire Form 1040 as submitted to the IRS.
- Multiple Schedule C's for a single sole owner: We will consider multiple Schedule C's for a single sole owner as affiliated based on common owners and management, regardless of industry.
- Multiple Schedule C's for Form 1040, "Married filing jointly": In cases where a Form 1040 is submitted as "Married filing jointly", we will determine whether each Schedule C is affiliated with the applicant firm based on common ownership and management and any other affiliation factors.

#### Scenario 1:

If the sole owner(s) of the applicant is also an owner of another Schedule C, we will consider the businesses affiliated, regardless of industry. It will be based on

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common ownership and management.

### Scenario 2:

If a husband is the sole owner of the applicant firm and has a Schedule C that belongs only to his wife, determine if any other affiliation factors exist; such as business relationship, shared facilities, employees, etc. If none of the other affiliation factors exist, they are not affiliated.

- **“Married filing separately” sole proprietorships:** In cases where spouses file separate returns and each spouse has one or more Schedule Cs within their respective Form 1040, we must determine if there is an affiliation between any of the spouses’ businesses. Consider all affiliation factors.

### **Affiliation: Community vs. Separate Property**

State law in which a married couple is domiciled generally governs whether the couple has community property and community income or separate property and separate income for federal tax purposes. The table below summarizes the general rules.

<b>Community Property</b> is ...	<b>Separate Property</b> is...
<ul style="list-style-type: none"> <li>• Property that the taxpayer, their spouse, or both acquire during marriage while they are domiciled in a community property state. (Includes the part of the property bought with the community property funds if part was bought with community funds and part with separate funds.)</li> <li>• Property that the taxpayer and their spouse agreed to convert from separate to community property.</li> <li>• Property that cannot be identified as separate property.</li> </ul>	<ul style="list-style-type: none"> <li>• Property that the taxpayer or their spouse owned separately before marriage.</li> <li>• Money earned while domiciled in a non-community property state.</li> <li>• Property either of the spouses were given or inherited separately after the marriage.</li> <li>• Property bought with separate funds, or exchanged for separate property, during the marriage.</li> <li>• Property that the spouses agreed to convert from community to separate property in an agreement valid under state law.</li> <li>• The part of the property bought with separate funds, if part was bought with community funds and part with separate funds.</li> </ul>

### **Affiliation: Form 1040, Schedule E.**

The investment, rental and/or royalties’ activity on the Form 1040, Schedule E, Page One is disregarded for GARs or affiliation purposes. However, any activity on the Form 1040, Schedule E, Page Two, Part II, should be reviewed for possible affiliation.

- **Passive vs. Non-passive:** We typically exclude passive activity and include non-passive activity for possible affiliation.
- **Passive Activity:** A passive activity is any trade or business activity in which a partner did not materially participate. A limited partner is generally treated as not having materially participated in a partnership. There are only two sources of *passive income*:

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1. A rental activity, regardless of the taxpayer's participation; or,
  2. A business in which the taxpayer did not materially participate.
- **Non-passive Activity:** A non-passive activity is any trade business activity in which a partner materially participates.
  - **Material Participation:** Material participation generally includes any work done in connection with an activity if someone owned an interest in the activity at the time they did the work. The capacity in which they did the work does not matter. However, work is not participation if:
    - It is work that an owner would customarily do in the same type of activity, and One of the main reasons for doing the work was to avoid the disallowance of losses or credits from the activity under the passive activity rules.
  - **Proof of Participation:** Participation can be established by any reasonable means, including but not limited to:
    - Identifying services performed over a period of time and the approximate number of hours spent performing the services during that period, based on appointment books, calendars, or narrative summaries.
    - For individuals, the person participated in the activity for more than 500 hours, or
    - The individual's participation in the activity was substantially all of the participation in the activity of all individuals (including individuals who did not own any interest in the activity).

### Affiliation Determination of a Farming Business

Use the affiliation factors to determine if affiliation exists between the applicant firm and the farming business.

- An individual is in the business of farming if they cultivate, operate, or manage a farm for gain or profit, either as owner or tenant income. Such business activity is reported on a Schedule F (Form 1040) and will be considered a business affiliation. *Material participation* applies to farming. (See Material Participation in Form 1040, Schedule E section above.)
- **Farm defined.** A farm includes stock, dairy, poultry, fish, fruit, or truck farm. It also includes plantations, ranches, ranges, and orchards. Other considerations include:
  - The sale of crop shares if the individual materially participates in producing the crop.
  - Operating a nursery which specializes in growing ornamental plants.
- **Rents (Including crop shares).** Rent received for use of farmland is generally rental income, not farm income. However, if an individual materially participates in farming operations on the land, the rent is farm income.
- **Pasture income and rental.** If an individual pastures someone else's cattle and takes care of the livestock for a fee, the income is from the individual's farming business. It is entered as *Other Income* on Schedule F.

### Affiliate Federal Tax Returns (FTR) [2 CCR § 1896.12(d)(1)]

The operational protocol for affiliate FTRs is:

- Obtain all affiliate FTRs for the previous three tax years. If the affiliate firm has been in business fewer than three tax years, obtain FTRs for the years the business has been in existence.

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- Use the following table to determine proper affiliate tax return submittal.

Applicant Firm Age	Affiliate Firm Age	Affiliate FTRs Required
3 years old and older	3 years old and older	current 3 years
3 years old and older	Less than 3 years old	current years
Less than 3 years old	3 years old and older	current 3 years
Less than 3 years old	Less than 3 years old	current years

### Using the Affiliation Chart

An affiliation exists when the following Affiliation Chart factors apply:

- Factor 1a by itself
- Factor 4b by itself
- Factor 5 by itself
- One
- One **Core** factor plus any three **Secondary** factors
- Two **Core** factors plus any one **Secondary** factor
- Any three **Core** factors
- Four **Secondary** factors

Once an affiliation has been established, then the affiliate(s) business(es) Federal Tax Returns (FTRs) for the three previous tax years are required to be submitted. The FTR submission and income for calculation purposes will be the same as listed in the OSDS Policy of Annual Gross Receipts and 01-2017OSDS Affiliates- Requiring 3 Years Tax Returns.

### The Affiliation Chart

Assists certification officers (COs) in making proper affiliation determinations according to the CCR:

- In weight order, ranks ten regulatory factors that either relate to *control* or *shared interests* that when applied, individually or combined, a stronger business relationship/affiliation between two firms can exist.
- Is broken into two categories:

**Core** factors – supposes a stronger business relationship between the two businesses and therefore an affiliation is more likely to exist

**Secondary** factors – more business relationship ties needed to demonstrate affiliation

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Step	Action
1	Analyze the certification application, Affiliate Information Form, and all support documents.
2	If a possible affiliate relationship exists between the applicant and another business, compare facts about the businesses' relationship with the factors in the Affiliation Chart.
3	Use the "Determining affiliation using the Affiliation Chart" process in the preceding block.
4	Ask applicant additional questions, if necessary.
5	Make affiliation determination.
6	Proceed with certification determination.

The **Affiliation Chart** is depicted in the following table.

	Factor Description	<i>Applicant</i>	<i>Other Firm</i>
<b>Co Factors</b>	<b>1. Controlling ownership</b> <ul style="list-style-type: none"> <li>Individually, or when combined with another person/entity's ownership, control is established</li> <li>Includes "shareholders"</li> </ul>		
	a. Has controlling ownership in <b>both applicant and other firm</b>	Owns ≥51%	Owns ≥51%
	b. Has controlling ownership in the <b>applicant firm</b>	Owns ≥51%	
	c. Has controlling ownership in the <b>other firm</b>		Owns ≥51%
	<b>2. Common ownership</b> <ul style="list-style-type: none"> <li>Has non-controlling ownership %</li> <li>Owners in both the applicant and the other firm</li> </ul>	Owns ≤49%	Owns ≤49%
		John & Mary Doe each own 1% of applicant	John & Mary Doe also each own 1% in Co. B
	<b>3. Common management</b> <ul style="list-style-type: none"> <li>Includes all management titles ("Owner"/"Officer"); not "shareholder"</li> <li>Directors with control</li> </ul>	VP	Treasurer
			↔
<b>4. Familial relationship</b> <ul style="list-style-type: none"> <li>a. Must be in similar industry</li> <li>b. Exception: Sole proprietorships with multiple Schedule Cs are affiliated. <ul style="list-style-type: none"> <li>Applicant must prove businesses are legally separate</li> </ul> </li> </ul>	Sister has C10 license	Brother has B license	
		↔	



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	<b>5. Agent/Broker relationship</b>	Commissioned rep. acts on behalf of other company	Takes title to goods
<b>Secondary Factors</b>	<b>6. Financial relationship</b> <ul style="list-style-type: none"> <li>Any financial assistance; any money exchange between two companies; money passing through for the receiving company's or mutual benefit</li> </ul>	\$ → \$	
	<b>7. Contractual relationships</b> <ul style="list-style-type: none"> <li>Ongoing or frequent agreements between two companies; contract assignment</li> </ul>	Contract	Contract
	<b>8. Shared facilities, equipment or systems</b>	707 3rd St., W. Sacramento, CA; Ph (916) 375-4940	707 3rd St., W. Sacramento, CA; Ph (916) 375-4940
	<b>9. Shared employee(s)</b>	John Doe, Admin. Asst.	John Doe, Accountant

### Affiliations and Trusts:

**Trusts** are not considered a 'business entity' and therefore trusts can 'own' the applicant and the applicant is still considered to be independently owned and operated. However, multiple businesses that are owned by the same trust are considered to be affiliates.

### Affiliation: FTB/SOS Suspended or Forfeited Firms

A business can be suspended or forfeited in California by (1) the Secretary of State (SOS) for failure to file a Statement of Information (SOI) and/or in the case of a domestic or foreign corporation, for failure to reimburse the [Victims of Corporate Fraud Compensation Fund \(VCFCF\)](#) for a paid claim; and/or(2) the Franchise Tax Board (FTB) for failure to meet tax requirements (e.g., file a return, pay taxes, penalties, interest). Per the Statement of Information (SOS) website, when a business entity has been suspended or forfeited, it is not in good standing and loses its rights, powers, and privileges to do the following in California:

- Legally do business
- Sell, transfer, or exchange real property
- File with an automatic extension
- File a claim for refund
- Start or continue a protest
- Legally close or dissolve your business
- Bring an action or defend your business in court
- File or maintain an appeal before the Office of Tax Appeals
- Maintain the right to use your business name

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- SOS will deny your revivor request if the entity name is no longer available.
- SOS will require your business to choose a new name
- Retain tax-exempt status.
- SOS will revoke an organization's tax-exempt status as of the suspension date.

A presumption of affiliation no longer exists when:

The other business' last Statement of Information (SOI) filed with the Secretary of State Office does not fall within the previous three tax years. (i.e. current submitted tax years are 2017, 2018, 2019; SOI filed 6/1/2015).

- A signed statement under penalty of perjury from an owner/corporate officer/member and/or manager that is involved with the firm regarding the status, including the last year income was generated from this firm.

If unsure, consult with management.

A presumption of affiliation still exists when:

The other business' last SOI filed with the Secretary of State Office does fall within the previous three tax years. (i.e. submitted tax years are 2017, 2018, 2019; SOI filed 4/1/2017).

When affiliation is presumed request the following documents:

- Required federal tax returns for each affiliate business
- The affiliated individual(s) most recent Form 1040 personal federal tax return to verify the presumed affiliated S-Corp, LLC or partnership on the Schedule E and sole-proprietorship on the Schedule C
- A signed statement under penalty of perjury from an owner/corporate officer/member and/or manager that is involved with the firm regarding the status, including the last year income was generated from this firm.

If only a signed statement is received, the certification officer will team with management before making a final decision. If unsure, consult with management.

In both cases, the firm should be listed as an affiliate on the application with an end date. Upon renewal, the status of the firm must be verified in SOS confirming it is still no longer conducting business. Enter a note on your checklist with an uploaded confirmation from SOS reconfirming the status. If the firm is still suspended/forfeited, you do not need to ask for another signed statement.

### Related Vendor:

Firms can be related vendors based on structure change and/or affiliation factors. Related vendors may or may not be determined to be affiliates. In either case, cross reference related vendor files by recording related vendor(s) and supplier numbers on the Certification Record Notes Screen.

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### **Joint Ventures:**

A joint venture is deemed an affiliate for certification purposes [2 CCR § 1986.12(d)(6)(C)].

### **Affiliation Rebuttal:**

Applicants may rebut the presumption of affiliation by providing a written justification with supporting documentation that demonstrates how the affiliation does not exist. Following review of the rebuttal and the determination that no affiliation exists, then affiliate federal tax returns and DE 9C forms will not be required for the alleged affiliated business(es).

### **The following type of business relationship shall not be considered affiliation [2 CCR § 1896.12(d)(6)(B)]:**

- A franchise and/or license agreement provided that the franchisee or licensee has the right to profit from its efforts and bears the risk of loss commensurate with ownership,
- A manufacturer's or service provider's representative provided that a written agreement exists between the manufacturer(s) or service provider(s) and the representative that substantiates the independent nature of the individual businesses.