warrant publication of this new proposed rule, included here as an integral part of SBA's overall regulatory streamlining.

In its 1994 proposal, SBA suggested reducing the common ownership threshold for any passive business and Operating Company to 20 percent. Most of the comments suggested that, as an exception to a ''mirror image'' requirement, a 20 percent threshold was insufficient to support a nexus between a passive business and an Operating Company. Some suggested that the nexus be increased to 50 percent, others to 80 percent. However, others suggested that SBA eliminate the ''mirror image'' rule altogether. After carefully considering all of the options, the goals and the objectives of SBA's loan programs, SBA proposes to eliminate the present alter ego rule, and allow such a loan whenever it essentially represents financial assistance to an Operating Company.

Many small businesses utilize separate entities to hold the real estate or leasehold improvements used in the operation of their businesses. SBA now believes that an Eligible Passive Company, without regard to its ownership interests, should be an eligible entity for SBA financial assistance if it only uses such assistance to acquire and/or improve real or personal property which it leases to an Operating Company for the conduct of its operations.

SBA's new proposed ''Eligible Passive Company'' rule recognizes that an Eligible Passive Company may be an individual, sole proprietorship, corporation, limited liability company, an irrevocable trust or any form of partnership. Under the current rule, trust ownership of any part of an Eligible Passive Company is prohibited in the SBA business loan program. The development company program permits the use of trusts as eligible owners. In this proposed rule (as in its 1994 proposal), SBA proposes to eliminate the inconsistency between the 7(a) loan program and the development company loan program. SBA believes that there is no reason to prohibit a small business concern using the SBA's business loan programs from taking advantage of the tax and planning benefits which may be inherent in the use of an irrevocable trust. Trust eligibility shall be determined by the eligibility status of the trustor (grantor/settlor), with all donors to the trust being presumed conclusively to have trustor status for eligibility purposes.

SBA welcomes comments on whether use of a revocable trust should also be permitted. While this would give Borrowers greater planning flexibility, the trustor's reserved authority to amend the trust might lead to fronts or other abuses. Under this proposed rule, an Operating Company must be an eligible small business under SBA's standards, and the proposed use of proceeds by the Eligible Passive Company would have to be an eligible use if the Operating Company were obtaining the financing directly. This ensures that the Eligible Passive Company will utilize SBA's financial assistance in the same manner as an eligible small business. As suggested by several comments on the 1994 proposal, both the Eligible Passive Company and the Operating Company must meet SBA's size standards (13 CFR Part 121).

In response to other comments on the 1994 proposal, the new rule clarifies that the lease between the Eligible Passive Company and the Operating Company must be subordinated to SBA's security interest, mortgage or trust deed lien and the Eligible Passive Company (as landlord) must pledge as collateral an assignment of rents derived from the lease. The requirement for an assignment of the lease has been eliminated, but an assignment may be required by SBA when necessary to perfect a lien under applicable law.

Several comments urged SBA not to require the Operating Company to be a co-Borrower on a loan to an Eligible Passive Company, suggesting that legitimate tax and business reasons exist in many cases for the Operating Company to be a guarantor instead of a co-Borrower. Believing this to be a credit and business decision best left to the discretion of SBA loan officers, the Borrower, and (in the development company program) the development company, SBA has provided that the Operating Company may be either a guarantor or a co-Borrower in most cases. An exception is created for loans in the 7(a) loan programs in which working capital funding is included, in which case the Operating Company must be a co-Borrower.

When an Operating Company applies for SBA loan assistance, each 20 percent or more ownership interest holder in the Operating Company must guarantee the loan. Since the Operating Company will be a co-Borrower or guarantor when an Eligible Passive Company is the Borrower, the proposed rule would extend the same requirement to ownership interests of both the Operating Company and the Eligible Passive Company.

Several comments noted that it is common for an Operating Company to need working capital when the Eligible Passive Company applies for a loan primarily to finance the acquisition of real or personal property. In the past, SBA has required the Eligible Passive Company to use the loan proceeds solely to acquire and improve property for lease to an Operating Company. Thus, two separate SBA loans would be needed—one to the Eligible Passive Company for the real property and the other to the Operating Company for working capital. The commenters suggested that SBA permit proceeds of a single loan to the Eligible Passive Company to be used for working capital in the Operating Company. This proposed rule adopts these suggestions for the 7(a) loan program, provided that the Operating Company is a co-Borrower. The loan proceeds for working capital would be allocated to the Operating Company, while those for acquisition and improvement of property for lease to the Operating Company would be allocated to the Eligible Passive Business. Under this approach, small businesses would no longer incur duplicate costs and would benefit by reduced paperwork and a streamlined loan process.

Several comments noted that a trust, established to take advantage of tax and planning benefits inherent in the trust form, may have a need to engage in other activities. They argued that SBA should not prohibit a trust which qualifies as an Eligible Passive Company from engaging in activities other than the leasing of property to the Operating Company. SBA agrees. Accordingly, under this proposed rule, a trust qualifying as an Eligible Passive Company may engage in other activities authorized under its trust documents. The Trustee will need to certify to SBA (and provide pertinent language from the trust document) that the Trustee has authority to act, and that the trust has the authority to borrow funds, pledge trust assets and lease the property to the Operating Company. The Trustee also will need to provide SBA with a list of all trustors and donors.

Note 3. To be eligible for SBA financial assistance, the products and services of a business must be available to the general public. Because the current rule refers only to recreational and amusement enterprises, it is misleading and confusing, and is not uniformly enforced by SBA field offices. The proposed rule clarifies that private clubs and businesses that limit the number of members for reasons other than capacity are ineligible for SBA financial assistance.

Note 4. The current regulations have separate conflict-of-interest sections for Lenders and development companies. SBA has re-written and consolidated the sections. The prohibitions are clear and consistent for all business loan program participants. The proposed rule expands the categories of individuals subject to the requirements and may encompass additional acts not specifically enumerated.

Note 5. The prohibition against assisting a business which previously has caused SBA to sustain a loss is currently stated explicitly only in the 7(a) regulations, although it is applied in all of SBA's business loan programs. Its inclusion in subpart A clarifies that the policy applies to all business loans. Considerable explanatory material currently in the 7(a) regulation has been removed and will be placed in an SOP or other policy guidance.

Note 6. SBA may provide financial assistance only if the applicant shows that the desired credit is needed and not otherwise available on reasonable terms. In § 120.101, SBA clarifies its present policy. The current provision, § 120.103–1 uses the language ''not otherwise available on reasonable terms'' without indicating any factors which should be considered in determining what is reasonable. Section 3(h) of the Act defines ''credit elsewhere'' as the availability of credit from non-Federal sources on reasonable terms and conditions taking into consideration the prevailing rates and terms in the community in or near where the concern transacts business, for similar purposes and periods of time. SBA believes the language in section 3(h) clarifies the credit elsewhere test and proposes to include the language in § 120.101. In addition, the current regulation provides that the certification made by a Lender in its application for an SBA guarantee is generally accepted as sufficient documentation that the desired credit is unavailable to the applicant. In the proposed § 120.101, SBA clarifies and reaffirms its existing policy that the Lender or CDC must have examined the availability of credit to the applicant, have based its