Trust Ownership Structures in SBA 504 Loans

by Thomas Wallace

The SBA's 504 Program, promotes economic development through financing capital assets. Lenders should consider the potential benefits to high net worth professional clients of trust ownership of assets thus financed.

The SBA 504 Program allows the financing of capital assets—buildings, equipment, related soft costs, and the like—with low down payments, ranging 10-20% of the total project cost. The balance of the funding comes from a private sector lender and a certified development company (CDC), generally in proportions of 50% and 30-40%, respectively.The private sector lender enjoys a first-position mortgage and security interest in financed assets, with the CDC/SBA in a second position. Given the relative security of the private sector lender's collateral position, very competitive pricing and loan terms are generally available. The second-position loan is priced at a fixed rate for a fully amortizing 20-year term with assumption allowed. In sum, it is a very attractive financing package.[1]

The benefits of the 504 loan structure can be even more distinct for high-net-worth professionals, for example, surgeons, lawyers, and accountants. The low down payment requirement preserves working capital for the future growth and development of a practice without resorting to other debt. The ability to broadly define project cost to include many types of soft costs or build-out requirements—whether structural or related to equipment needs—assists in the preservation of working capital. Finally, cash flow—for the funding of planned investment patterns for retirement or for family needs—is preserved by the structure of the debt, a long-term amortization in the 504 portion, and the opportunity for a longer term and amortization in the lender's first position loan.

The benefits to a lender of this product are equally apparent. In preserving the availability of cashflow, as well as in creating a superior collateral position, the lender has structured an especially secure credit exposure. This can either accrue to the general benefit of the portfolio or be more immediately recognized through a specific lower loan loss reserve allocation. The lender also has created a much more marketable credit product mix through the availability of long-term, fixed-rate financing. The 504 Program's limited restrictions on the structure of the first-position mortgage also can be turned to good account by offering the full spectrum of engi-

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neered credit offerings to tailor a loan uniquely suited to the borrower's needs.[2] Finally, the specific loan structure—placing the title to the acquired capital asset into a trust environment—inherently lends itself to the cross-selling of investment products and other financial services.

The placement of significant financial assets under the legal separation of a trust may also be of benefit to high-net-worth professionals. Examples of this could range from protection of assets in litigation to the more universally needed benefits of trust status in estate planning. In certain circumstances, these protections also could be of value to lenders, as in the case of keeping an asset outside of probate.

Trusts are a relatively complex topic, given the considerations particular to an individual client's situation. The objective of this article is not to review overall trust strategies but rather to view how the varied benefits of trust asset protection can be used within the requirements of the SBA regulatory environment.

SBA regards the question of trust ownership of financed assets as a subset of the regulations that determine the eligibility of a borrower. The key regulatory issues are that a borrower is determined to be a "small business" and that any assets financed meet the requirements of being more than an investment. SBA's perceived mission and the legislative intent of the program is to assist the operations of a small business, not the speculative or passive investments of a small business's principals.[3] There are, however, clear advantages to a small business owning its place of operations, as well as distinct legal benefits to owning these premises outside of the operating entity of the business. This leads to a long debate as to how and when SBA could, or should, assist in the financing of real estate purchases for an otherwise eligible small business. The *eligible passive company rule* is the result of this debate. As it specifically relates to trusts owning an SBA-financed capital asset, regulations require the following limiting conditions:

1. The trustor must be eligible by SBA standards.
2. All donors to the trust are considered as trustors.
3. All trustors must guarantee the loan.
4. The trust must represent and warrant that it will not be substantially amended or revoked for the life of the loan.[4]

Luckily, eligibility under the 504 loan program is far less complex than for the 7(a) program. As it relates to the issue of business size, any business with a tangible net worth of less than $7 million and after-tax net income averaging less than $2.5 million over the preceding two years is eligible. Principals and the immediate family of the borrowers or the "eligible passive company" also must meet an excess liquidity test. (Principals include anyone owning 20% of a project.) The test relates the size of the total project being financed—using a very broad definition—to an upper limit for liquidity, net of exemptions, as either a flat-dollar amount or a multiple of the total financing package. The relationship is outlined in the following table:

Total Financing Package	Allowable Maximum Liquid Assets
< $250,000	2 × total financial package or $100,000, whichever is greater.
$250,001 - $500,000	1.5 × total financial package or $500,000, whichever is greater.
> $500,001	1 × total financial package or $750,000, whichever is greater.

Liquid assets are defined as "cash or cash equivalent, including savings accounts, CDs, stocks, bonds, or other similar assets." Specifically excluded are real estate equity, closely held nonmarketable stocks, IRAs, 401(k)s, Keogh plans, or other established retirement plans subject to withdrawal penalties and restrictions.[5] Given the relative liberality of this definition, most will still qualify as eligible borrowers.

The balance of eligibility issues relate to prohibited business lines, citizenship or legal residence issues, and moral and ethical considerations. These regulations can be summarized in less than two pages. Outside of citizenship or legal residence status issues, these should rarely constitute an eligibility issue for most successful professionals. As citizenship or legal residence issues are beyond the scope of this article, a local CDC can provide answers to situation-specific questions.

In sum, while all donors to the trust must be determined eligible, there are limited obstacles to eligibility and the determination is relatively straightforward. However, all trustors must be guarantors of the loan, which may in certain circumstances present administrative or marketing issues. It

must also be noted that the 504 Program has a specific and definite job-creation requirement that, while important in the overall program, can be less of an issue in certain transactions because of the manner in which performance under this requirement is measured.

The current regulations also clearly define two other issues that serve to increase the attractiveness of this ownership structure. The first is that the trust itself does not have to meet eligibility requirements, either in size or in the business lines it is engaged in. This could radically enhance the benefit of the 504 Program to a high-net-worth professional who has or is contemplating transferring significant assets to a trust environment as part of an estate-planning process. Given an application lead time of at least six months due to other regulatory issues, prospective borrowers' financial situations could be reasonably structured to render them eligible for the benefits of a 504 loan by placing assets into a trust as part of legitimate estate planning moves. In an environment involving the new construction of a practice facility, this is not an unreasonable time frame.

Finally, beneficiaries of the trust do not have to guarantee the loans made under the 504 Program if the asset is titled in the name of the trust. This provides the "icing on the cake" for a planned asset transfer environment.

Table 2 follows an outline of a sample transaction in terms of when equity contributions and loans are made:

Pro Forma 504 Loan Transaction with Trust Ownership	
Grantor places requisite equity into trust—existing or specifically formed.	10-20% of Project Cost
Bank makes a bridge loan for acquisition/construction/installation of capital asset. (Loan is made to the trust, grantors guarantee asset is titled in the name of the trust.)	80-90% of Project Cost
After certificate of occupancy/completion or title is acquired, CDC funds the debenture. (Debenture rate fixed for 20 years and begins amortization; permanent lender loan begins amortization, at rate structure negotiated between Lender and Borrower.)	Permanent lender retains 50% of project cost, first position.CDC funds 30-40% of project cost, second position.
Repayment of loan(s) comes from lease between operating company & trust.	

Remaining collateral conditions are generally not onerous, including the normally anticipated range of insurance coverage, environmental audits, and appraisals. The terms of the lease between the trust and the operating company can allow only for reasonable expenses to be drawn from the operating company and it should be expected that the lease will be collaterally assigned.

Trust environments are a basic tool of wealth management and estate planning that are increasingly used by professionals with high earnings capacity as well as those who already have successfully accumulated significant net worth. A trust functions as a way to protect and to transfer assets that these individuals amass. When combined with the allowable leverage and financial term benefits of the 504, they can help various professional accomplish these goals while also continuing the orderly growth and development of their practice. In this way, they contribute to the main goal of the 504 Program by creating economic development through job creation. The combination of these two mutually compatible goals results in a highly beneficial situation for lenders, as they are building their community and thus building their own institutions through prudent lending. That the nature of the credit structure also affords several avenues for the cross-selling of other financial products and services is merely the reward for being diligent in exploring the option available to the institution and its clients. ❐

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Notes

1 Wallace, Thomas. "SBA 504 Loans: An Underused Product That Helps Community Banks," *The RMA Journal,* April 2001, pages 26-31.

2 The most critical program requirement is that the term of the first position loan be no less than seven or 10 years, depending on the term of the second position loan, ranging from 10 to 20 years.

3 13 CFR 120.110(c), SOP 50-10(4)(E), pages 45 to 50-2.

4 Sample language for this representation and warranty is available, under "Publications" at www.srdcorp.org.

5 13 CFR 120.120.102, SOP 50-10(4)(E), pages 15 to 23-4. Using the logic inherent in this position, it can be proposed that favorable rulings should be obtainable for funds held in disability trusts and educational savings plans.