200. PRINCIPLE

Necessary and proper interest on both current and capital indebtedness is an allowable cost.

202. DEFINITIONS

202.1 Interest.--Interest is the cost incurred for the use of borrowed funds, generally paid at fixed intervals by the user. Interest on current indebtedness is the cost incurred for funds borrowed for a relatively short term, usually for 1 year or less. Current borrowing is usually for purposes such as working capital for normal operating expenses. Interest on capital indebtedness is the cost incurred for funds borrowed for capital purposes, such as the acquisition of facilities, equipment, and capital improvements. Generally, loans for capital purposes are long-term loans.

Interest is usually expressed as a percentage of the principal. Sometimes, it is identified as a separate item of cost in a loan agreement. Interest may be included in finance charges imposed by some lending institutions or it may be a prepaid cost or discount in transactions with those lenders who collect the full interest charges when funds are borrowed. Reasonable finance charges and service charges together with interest on indebtedness are includable in allowable cost.

To be allowable under the Medicare program, interest must be:

- o Supported by evidence of an agreement that funds were borrowed and that payment of interest and repayment of the funds are required;
- o Identified in your accounting records;
- o Related to the reporting period in which the costs are incurred; and
- o Necessary and proper for the operation, maintenance, or acquisition of your facilities.

To support the existence of a loan, have available a signed copy of the loan contract which contains the pertinent terms of the loan such as amount, rate of interest, method of payment, due date, etc. Where the lender does not customarily furnish a copy of the loan contract, correspondence from the lender stating the pertinent terms of the loan such as amount, rate of interest, method of payment, due date, etc., is acceptable.

Where funds are borrowed from your funded depreciation account or other restricted funds, authorization from your appropriate officials must be on file. Your appropriate officials include the persons to whom responsibility for the management of the restricted amounts or funds has been granted, such as the board of trustees, financial committees, or other individuals or groups, as appropriate in the particular case.

Various methods of identifying and accounting for interest costs are used. These include periodic cash payments of interest with or without repayment of all or part of the loan; prepayment of interest when the liability is incurred with charges to interest expense recorded in relation to the accounting period; and accrual of interest with no cash payment with a corresponding record of the unpaid liability reflected in the accounting records. The method actually used depends on the type of loan and the terms of the loan agreement.

Where interest expense has been determined to be allowable and the interest expense records are maintained physically away from your premises, such as in a county treasurer's office, such records are deemed to be yours. This is applicable where bond issues have been specifically designated for the construction or acquisition of your facilities and the financial records relative to the bond issue are maintained by some governmental body other than you.

Interest expenses are not allowable if incurred as a result of:

o A judicial review by a Federal court resulting in a reversal of an adverse decision to the provider by the PRRB or the HCFA Administrator (as described in 42 CFR 413.64(j));

o An interest assessment on a determined Medicare overpayment (as described in 42 CFR 405.376); or

o Interest on funds borrowed to repay an overpayment (as described in 42 CFR 413.64(j)) up to the amount of the overpayment, unless the provider had made a prior commitment to borrow funds for other purposes (e.g. capital improvements). If a previously determined Medicare overpayment is administratively or judicially reversed at a later date, interest paid on funds which were borrowed to repay such overpayment is considered to be an allowable cost.

When a provider overpayment is determined to exist, any borrowing during the period(s) the overpayment is being repaid, up to the amount of the overpayment, is considered a nonallowable cost and any interest is not allowable. Such borrowings are assumed to be related to the overpayment itself and not directly or indirectly related to patient care services. Only in those instances where the provider can show that the borrowing would have been necessary, even if the overpayment had not occurred, will the interest be allowable.

202.2 Necessary.--Only interest expense which is necessary is an allowable cost. To be considered necessary, the interest must be:

- o Incurred on a loan that is made to satisfy a financial need,
- o For a purpose related to patient care, and
- o Incurred on a loan that is reduced by investment income.

If a borrowing or a portion of a borrowing is considered unnecessary, the interest expense on the borrowing, or the unnecessary portion of the borrowing, is not an allowable cost. The repayment of the funds borrowed is applied first to the allowable portion of the loan. The allowable interest for a year is determined by multiplying the total interest for the year by the ratio of the allowable share of the loan to the total amount of the loan outstanding. The ratio is based on the loan balance (allowable and total) at the beginning of the cost report year. (The balance at the beginning of the cost report year is used without regard to the schedule of the payments, i.e., monthly, quarterly.) Since the allowable part must be paid first, the ratio will change each year.

For example, if $200,000 of a $400,000 loan is considered necessary, interest is allowable on $200,000 of the loan. The loan principal is paid at $60,000 the first year, $70,000 the second year, and $75,000 the third year. The ratio for determining the allowable share of the interest for the first year is 200,000/400,000 (50%), 140,000/340,000 (41%) for the second year, and 70,000/270,000 (26%) for the third year.

Patient care funds should be available for the provider's patient care purposes, enabling it to avoid interest expense attributable to unnecessary borrowing. When a provider diverts patient care related funds to other uses, there is an impact on any subsequent borrowing. Funds may be diverted in many ways with the most common being by transferring, making loans, or investing. Generally, a transfer is the assignment or conveyance of property or assets from one person or entity to another. The transfer vests in the receiver the rights that the transferor had therein. Transfers are addressed in subsection A. A loan, which is also addressed in subsection A, is generally the furnishing of something for temporary use with the agreement, expressed or implied, to repay it with or without interest. Investments, addressed in subsection C, are generally expenditures to acquire property or other assets in order to produce revenue or profit or the placing of money or property in business ventures or real estate so that they may produce revenue or gain.

A. Financial Need.---When borrowed funds create excess working capital, interest expense on such borrowed funds is not an allowable cost. Borrowing for a purpose for which funded depreciation account funds should be used makes the borrowing unnecessary to the extent that funded depreciation account funds are available at the time of the borrowing. (See §226C.) Unrestricted funds derived from grants, gifts, and endowments are not considered in the determination of excess working capital or the necessity of external borrowing. The burden of proof to show that there is a financial need for the borrowing and that the borrowing does not result in excess working capital rests with the provider.

If a provider transfers funds generated from patient care activities (or any funds that cannot be documented as funds not generated from patient care activities) to an organization related to the provider, as defined in Chapter 10, the funds transferred are considered available to the provider. If such funds could have been used to eliminate a borrowing or to result in a lesser borrowing, a portion of the borrowing equivalent to the amount transferred is considered unnecessary. Interest on that portion of the loan is not allowable. If part of a loan is considered unnecessary, repayments of the funds borrowed are applied first to reducing the allowable portion of the loan.

If funds generated from patient care are used to repay an unallowable borrowing, it is considered an investment of patient care related funds. Any investment income generated from the investment is used to offset otherwise allowable interest expense.

Any funds that cannot be documented as funds not generated from patient care are considered as funds generated from patient care. Where there are commingled funds, it is presumed that the commingled funds include funds generated from patient care activities unless the provider records are sufficient to overcome this presumption. The burden of proof to show the sources and application of funds within a chain organization rests with the chain organization.

If the transferred funds are properly designated funded depreciation, see §226.1.
The following examples represent simplified situations and are only for the purpose of illustrating general principles.

EXAMPLE 1: Provider A transfers $100,000 of funds generated from patient care activities to the home office. Later, Provider A needs $500,000 to purchase some new equipment. It has $200,000 in funded depreciation available and borrows the balance ($300,000). Only $200,000 of the $300,000 loan is considered necessary and only the interest on that portion of the loan is allowable. The $200,000 transferred to the home office is considered available to the provider. The loan is for 4 years at 12 percent interest. The allowable interest expense is determined as follows.

The repayment of the funds borrowed is applied first to the allowable portion of the loan. The allowable interest is a proportion of the total interest for the year based on the ratio of the allowable share of the loan to the total amount of the loan outstanding. The ratio is based on the loan balance (allowable and total) at the beginning of the cost report year. The allowable interest for the year is determined by multiplying the total interest paid during the year by the applicable ratio. The allowable interest expense is determined as follows.

	Total Loan	Allowable Share	Nonallowable Share
1st Year			
Beg. Bal.	$300,000	$200,000	$100,000
Principal	62,146	62,146	0
End. Bal.	$237,854	$137,854	$100,000
Interest	$ 32,656	$ 21,770	$ 10,886

The ratio to determine the allowable share is 200,000) 300,000.

2nd Year			
Beg. Bal.	$237,854	$137,854	$100,000
Principal	70,028	70,028	0
End. Bal.	$167,826	$ 67,826	$100,000
Interest	$ 24,774	$ 14,358	$ 10,416

The ratio to determine the allowable share is 137,854) 237,854.

3rd Year			
Beg. Bal.	$167,826	$ 67,826	$100,000
Principal	78,909	67,826	11,083
End. Bal.	$ 88,917	$ 0	$ 88,917
Interest	$ 24,774	$ 10,012	$ 14,762

The ratio to determine the allowable share is 67,826) 167,826.

EXAMPLE 2: Provider A loans funds generated from patient care activities to Provider B, a member of the same chain organization (but not connected through a religious affiliation). Subsequently, Provider A needs funds for a patient care related purpose and borrows money. For Provider A, the borrowing is not considered necessary and the interest expense is not allowable.

Because they are related organizations, the interest on the loan from Provider A is not an allowable expense for Provider B. In addition, the interest paid by Provider B to Provider A is not investment income to Provider A.

EXAMPLE 3: Provider A loans funds generated from patient care activities to a nonrelated provider, Provider C. Subsequently, Provider A needs funds for a patient care related purpose and borrows the money. For Provider A, the borrowing is considered necessary and the interest is allowable.

The interest paid by Provider C to Provider A is considered investment income and is offset against Provider A's interest expenses. If the loan to Provider C meets the requirements in §202.1, the interest is an allowable expense to Provider C.

Interest expense incurred under an interest rate swap agreement is not recognized for Medicare payment purposes because the interest expense incurred under such agreement does not result from a loan made to satisfy a financial need of the provider.

EXAMPLE: Hospital A has $10 million in bonds at a variable interest rate of prime plus 2%. The bonds were issued for a patient care related purpose and the interest is an allowable expense under Medicare. The hospital prefers a fixed rate and enters into a swap interest rate agreement with a bank. The amount of the note is $10 million. The agreement stipulates that the hospital will pay the bank a fixed rate of 12% and the bank will pay the hospital a variable rate of prime plus 2%.

For the first year, prime remains at 10% and there is no exchange of funds between the bank and the hospital. For the second year, the prime drops to 8%. The hospital pays the bank $200,000 in interest. This interest is NOT reimbursable under Medicare. For the third year, the prime rate increases to 12%. The bank pays the hospital $200,000. This is NOT considered investment income for Medicare reimbursement. The transaction has no impact on the allowability of the interest expense associated with the bonds.

B. <u>Purpose Related to Patient Care.</u>---Where funds are borrowed for purposes of investing in other than the provider's own patient care related activities, interest expense is not allowable. Such a loan is not considered necessary.

C. <u>Offset By Investment Income.</u>--Patient care funds should be available for the provider's patient care purposes, enabling it to avoid interest expense attributable to unnecessary borrowing. If funds generated from patient care activities are invested in nonpatient care related activities, the provider's allowable interest expense is reduced (offset) by the provider's investment income in order to determine the amount of interest expense that is necessary and therefore allowable. The investment income is only offset against allowable interest expense. See §2806.1.G.

Investment income for offset is the aggregate net amount realized from all investments of patient care funds in nonpatient care related activities and may include interest, dividends, operating profits and losses, and gains and losses on sale or disposition of investments. The methodology for determining the amount of the investment income is determined in part by whether the investment is in a related or unrelated organization. While investments in another organization may be accounted for under either the cost method or the equity method for financial accounting purposes, it is the relatedness of the organizations that determines the methodology for determining investment income offset for Medicare payment purposes. If the organizations are related, investment income offset is determined under subsection 2. If they are not related, then subsection 1 applies.

Excluded from the definition of investment income is the investment income from:

- o Grants, gifts, and endowments, whether restricted or unrestricted,
- o Funded depreciation (see §226.2),
- o Qualified pension funds (see §228),
- o Deferred compensation funds (see §2140.3.C.3),
- o Interest earned as a result of judicial review by a Federal Court (as described in 42 CFR 413.64(j), and
- o Nonallowable borrowing.

Investment income from the following is not offset if the funds comply with the requirements in §2161.B:

- o Self-funded health insurance,
- o Self-funded worker's compensation, and
- o Self-funded unemployment insurance.

If the amount of investment income is unknown or the investment income is not yet realized, the amount cannot be imputed.

See §206 for the treatment of interest during a period of construction.

See §202.6 for special rules regarding the treatment of investment income resulting from a pooling of funds for investment purposes.

See §2806.1G for the requirements regarding investment income offset for hospitals reimbursed under the prospective payment system.

See §213.B for interest income on zero coupon bonds and §233.3D for interest income associated with advance refunding.

Any investment income (subject to offset) in excess of allowable interest expense is not used to offset other expenses. If the aggregate net amount realized from all investments of patient care related funds is a loss, the loss is not allowable. The net loss is not added to interest expense and it is not an allowable expense. Where operating losses occur, there should be assurance that they are bona fide and do not represent any form of subsidy to the provider, its employees, hospital based physicians, etc. For example, the loss realized by a subsidiary corporation holding rental property available to physicians at below costs is not bona fide. It is not included in the calculation of investment income.

Investment income resulting from investment of funds not generated from patient care activities is not subject to offset. In addition, if the funds invested in nonpatient care activities are borrowed, the interest expense is not allowable and the investment income is not subject to offset.

Situations involving investment income can be quite complex and can take many forms. The following examples represent simplified situations and are for the purpose of illustrating general principles.

EXAMPLE 1: A hospital downsizes and sells some of its patient care assets. The profit or loss on the sale is determined under §130. The provider invests the funds derived from the sale in an interest bearing account. The income from the investment is subject to offset. The funds from the sale are considered patient care related funds.

EXAMPLE 2: Hospital A borrows a sum of money and invests it in Hospital B. Interest expense incurred on a loan not related to the provider's own patient care is not an allowable expense. After a period of time, Hospital B begins to make a profit and provides a return to Hospital A. The interest on the loan is not allowable and the investment income realized from the asset is not offset against Hospital A's interest expense. There is no offset of the investment income that results from the investment of borrowed funds.

EXAMPLE 3: In each of the following cases, the hospital has excess operating funds of $20 million which were earned in 1995. It has no funded depreciation funds available. The excess operating funds are in a savings account drawing interest, creating investment income for the hospital.

Case 1.--There are no borrowings related to patient care and therefore no allowable interest expense. Because there is no interest expense, there is no offset of the investment income. Investment income (subject to offset) in excess of allowable interest expense is not used to offset other expenses.

Case 2.--There is a patient care related loan outstanding which was made in 1985. The investment income is used to offset the interest expense.

Case 3.--There is a patient care related loan outstanding which was made in 1985. The investment income from the savings account is being used to offset the interest expense. The provider wants to borrow an additional $20 million. If additional money is borrowed, the loan is considered unnecessary, and the interest expense is not recognized. However, the investment income is no longer used to offset the interest expense on the first loan.

Since the interest expense on the second loan is not recognized as allowable because the provider should have used the $20 million in savings, the same $20 million can not be used to offset the interest expense on the first loan. As long as the $20 million is used in determining the necessity of the borrowing, the interest is not offset.

EXAMPLE 4: In each of the following cases, the hospital invested $2 million of funds generated from patient care activity in 1995 in a non-patient care related business that is not easily liquidated. The business generates investment income of $100,000 a year.

Case 1.--The hospital has no patient care related interest expense. Because there is no interest expense, there is no offset of the investment income. Investment income (subject to offset) in excess of allowable interest expense is not used to offset other expenses.

Case 2.--The hospital has bonds issued in 1992 for a patient care related purpose on which it is paying interest of $90,000 a year. All of the interest expense is offset by the investment income. The excess investment income of $10,000 is not offset against other expenses.

Case 3.--The hospital has bonds issued in 1992 for a patient care related purpose on which it is paying interest of $90,000 a year. All of the interest expense is offset by the investment income. The hospital now wants to borrow $1 million for a patient care related purpose. The loan is considered necessary and the interest expense is offset by investment income.

Case 4.--The hospital has no patient care related debt and wants to borrow $1 million. The loan is considered necessary and the interest expense is offset by the investment income. This differs from Example 3, Case 3, where the funds are available. In this case, the business would have to be liquidated.

1. Investments In Unrelated Organizations.--Investment income arising from the investment of funds generated from a provider's own patient care activities in unrelated providers or nonpatient care activities, corporations (including the purchase of stock), partnerships, etc., consists of the aggregate net amount realized from dividends, interest, net rental income, interest earned in temporary investment of withholding taxes, as well as all gains and losses except gains or losses realized from the disposal of assets used for the production of income in the ordinary course of business. If the aggregate net amount realized is a loss, the loss is not allowable. Any profit is treated as investment income and must be offset against interest expense in the same cost reporting period.

When a provider purchases stock in an unrelated organization, the investment income consists of dividends paid on the stock as well as any gain or loss on the eventual sale of the stock. If the stock is in a related organization, see subsection 2.

EXAMPLE: A hospital invests $10,000,000 in a physician's office building. The hospital uses $5,000,000 from funds generated from patient care and borrows the balance. This is not a related organization as defined in §§1000ff.

Since a portion of the funds invested represents funds generated from patient care, a portion of the aggregate net income equal to the ratio of funds generated from patient care to total funds invested must be offset against interest expense. In this case, 50 percent of the funds invested are from patient care activities, so 50 percent of the investment income is used to offset the hospital's allowable interest expense. Fifty percent of the investment income continues to be offset against interest expense even if or when the funds generated from patient care are repaid.

There is no offset of the investment income that results from the borrowed funds. The interest expense on the funds borrowed is not allowable because the office building represents an investment in other than patient care activities.

This example presumes that repayment of the borrowing is not with funds generated from patient care. If funds generated from patient care related activities are used to repay the borrowed funds, or any part of the borrowed funds, the payment is considered an investment of patient care funds and the percentage related to investment increases.

2. Investments in Related Organizations or Directly Owned Assets.-If a provider diverts its funds generated from patient care to invest in nonpatient care activities directly owned by the provider or in a related organization as defined in §1000ff, the funds generated are considered as investment income for purposes of the investment income offset. Investment income arising from the investments in related organizations, activities, corporations, subsidiaries, etc., consists of the provider's share of the related entity's net annual profits or losses as determined under generally accepted accounting principles. Any gain or loss on the eventual sale of the related organization is adjusted for undistributed profits/losses which had previously been offset. Investment income arising from nonpatient care activities directly held by the provider (included in the provider's books) is determined under Medicare cost finding principles.

If a provider purchases stock in a related corporation, investment income is calculated based on its share of the related corporation's net operating profit and losses rather than dividends. If the investment in the related corporation is sold, any gain or loss realized on the sale also constitutes investment income. The original investment in the stock must be reduced by any dividends received and adjusted to add any profits and subtract any losses realized each year as investment income before calculating the gain or loss on the sale of the stock. If the aggregate net amount realized on the investments is a loss, the loss cannot be claimed in reimbursement.

EXAMPLE: A hospital invests $50,000 of patient care funds in the purchase of 75% of the stock of a medical supplier. The medical supplier meets the definition of a related organization in §§1000ff. The stock was later sold for $75,000. During the period the hospital owned the stock, the medical supplier generated profits of $20,000 for the hospital which were offset on an annual basis. Also, during the period of ownership, $8,000 was distributed. Because this is an investment in a related organization, the gain or loss on the sale is determined as follows:

Original investment	$ 50,000
Profits (offset as investment income)	+ 20,000
Distributions received	- 8,000
Adjusted basis	$ 62,000

Sale price	$ 75,000
Adjusted basis	- 62,000
Gain on sale	$ 13,000

The $13,000 gain on the sale is investment income and is used to offset interest expense.

202.3 Proper.--Proper means that the interest be incurred at a rate not in excess of what a prudent borrower would have had to pay in an arm's-length transaction in the money market when the loan was made. In addition, the interest must be paid to a lender not related to you through common ownership or control. (See Chapter 10, Cost to Related Organizations, for the definition of common ownership and control.) An exception to the general rule regarding interest on loans from controlled sources of funds is provided in §§218.2 and 220.

If unrestricted funds are used to make "loans" to the general fund of the provider for use in current operations, or for other purposes, interest paid by the general fund to the unrestricted fund is not allowable as a cost. Unrestricted funds are available for the use of the provider, and the provider should use them rather than "borrow" them.

If a provider's donor-restricted funds make loans to the general fund of the provider, the interest paid by the general fund to the restricted fund is included in allowable cost at a rate not to exceed the interest rate the fund is currently earning. If these funds are borrowed for construction purposes, the interest paid to the fund during the period of construction is capitalized as part of the cost of construction and recovered as allowable depreciation. Total investment income earned from the temporary investment of "necessary" funds borrowed for construction purposes must be offset at the end of the construction project against total interest expense incurred during the period of construction to determine the net amount of interest expense to be capitalized. While an excess of construction interest expense must be capitalized, an excess of investment income earned on borrowed construction funds should not be offset against other interest expense or other operating expenses of the provider.

202.4 Prepaid Interest.--Prepaid interest is the excess of the face value of a loan over the proceeds of the loan. It is the payment of interest in advance of the period over which the interest expense is incurred.

202.5 Finance Charges.--Some lending institutions include in the costs of loans, expenses related to the maintenance of records, collection of delinquent accounts, administration, etc., in addition to the charges for interest. The total of all these costs is known as finance charges, carrying charges, etc.

202.6 Pooling of Funds for Investment Purposes.--A provider may combine or "pool" various funds in order to maximize the return on investment by investing one large, rather than separate, smaller amounts. Part or all of various funds are placed in common investments, such as certificates of deposit, common stock, bonds or "NOW" accounts. Where funds are pooled, proper records must be maintained to preserve the identity of each fund in the pool in order to permit the earned income and the realized or unrealized gains and losses from investments to be related with the source. In order to accomplish this, the accounting for a pooling for investment purposes must utilize an appropriate fund valuation method, such as the market value method referred to in Chapter 4 of the AICPA Hospital Audit Guide. Fund valuation is essential where pooled investments are made so that identity of the funds and their value in relation to the total pool can be determined. This is necessary so that each fund comprising the pool can be properly identified, particularly where the pool includes funds that are subject to the investment income offset. Where the composition of the pool is undergoing change, valuation is also essential to record the relative value of new additions and to determine the true equity of withdrawn funds. The method elected by a provider must be followed consistently from one cost reporting period to another. Any change in method must be elected prospectively and shall be subject to intermediary approval.

203. INTEREST ON LOANS IN EXCESS OF ASSET VALUE, ACQUISITION AFTER JULY 1970

A. Where a loan is obtained to finance the purchase of a facility or a tangible asset (or group of facilities or tangible assets) that is acquired after July l970, and the purchase price exceeds the historical cost (see Section l04.l0) or the cost basis (see Sectionl04.l4), whichever is appropriate, interest expense on that portion of the loan used to finance the excess is not considered reasonably related to patient care and is not allowable.

B. The owner's investment in the acquisition of the facilities or tangible assets is first applied to the tangible assets related to patient care, then to the intangible assets related to patient care (e.g., certain patents, copyrights, etc.), and lastly to tangible and intangible assets not considered reasonably related to patient care and goodwill.

C. Where the owner's investment is less than the cost allowed for the assets related to patient care, the interest on any additional funds borrowed apply first to the portion of the allowable cost of the tangible assets related to patient care not covered by the owner's investment, then to the intangible assets related to patient care, and lastly to tangible and intangible assets not considered reasonably related to patient care and goodwill.

D. Repayments of the funds borrowed are applied first to reducing the portion of the loan applied to the allowable cost of the patient care assets, then to the tangible and intangible assets not considered reasonably related to patient care, and lastly to goodwill.

EXAMPLES:

1. Allocation of Loan.--

Purchase price of facility	$800,000
Allowable cost of facility for program purposes	- 600,000
Excess of purchase price over allowable program cost	200,000

Owner's investment in acquisition	350,000
Amount borrowed	450,000

Amount of loan on which interest is allowable:

Allowable cost of facility	$600,000
Less owner's investment	350,000
Interest expense allowable on loan of	$250,000

(Repayments on the amount borrowed--$450,000--are applied first to reducing that part of the loan on which interest expense is allowable--$250,000.)

2. Computation of Interest Expense.--

	Total Loan	Allowable Share of Loan	Nonallowable Share of Loan	Allowable Interest Expense (7% Loan)
1st Year				
Loan Balance-1/1	450,000	250,000	200,000	
Payment-12/31	30,000	30,000	-0-	$17,500
Loan Balance-12/31	420,000	220,000	200,000	($250,000x7%)
2nd Year				
Payment-12/31	30,000	30,000	-0-	$15,400
Loan Balance-12/31	390,000	190,000	200,000	($220,000x7%)
3rd thru 8th Years				
Payments	180,000	180,000	-0-	
Loan Balance-12/31/8th Year	210,000	10,000	200,000	
9th Year				
Payment	30,000	10,000	20,000	$ 700
Loan Balance-12/31	180,000	-0-	180,000	$ 10,000x7%)

204. MORTGAGE INTEREST

A mortgage is a lien on assets given by a borrower to a lender as security for borrowed funds for which payment will be made over an extended period of time. Mortgage interest refers to the interest expense incurred by the borrower on a loan which is secured by a mortgage. Usually such loans are long-term loans for the acquisition of land, buildings, equipment, or other fixed assets.

Mortgage loans are customarily liquidated by means of periodic payments, usually monthly, over the term of the mortgage. The periodic payments usually cover both interest and principal. That portion which is for the payment of interest for the period is allowable as a cost of the reporting period to which it is applicable.

In addition to interest expense, other expenses are incurred in connection with mortgage transactions. These may include attorney's fees, recording costs, transfer taxes and service charges which include finder's fees and placement fees. These costs, to the extent that they are reasonable, should be amortized over the life of the mortgage in the same manner as bond expenses. The portion applicable to the reporting year is an allowable cost.

206. INTEREST DURING PERIOD OF CONSTRUCTION

Frequently, providers may borrow funds to construct facilities or to enlarge existing facilities. Usually, construction of facilities will extend over a long period of time, during which interest costs on the loan are incurred. Interest costs incurred during the period of construction must be capitalized as part of the cost of the facility. The period of construction is considered to extend to the date the facility is put into use for patient care.

If the construction is an addition to an existing facility, interest incurred during the construction period on funds borrowed to construct the addition must be capitalized as a cost of the addition. After the construction period, interest on the loan is allowable as an operating cost.

Where a bond issue is involved, any bond discount and expense, or bond premium amortized during the period of construction, is included in the capitalized cost of the facility constructed.

208. INTEREST ON LOANS; ALLOCATION

A. Asset Acquired Prior to August l970.--Where a loan is made to construct, or acquire, a number of buildings (or other fixed assets), the interest on the loan applies to the several assets acquired in proportion to the cost each asset bears to the total cost of the assets. If any building or other asset covered by the loan is not used for purposes related to patient care, the interest applicable to such asset is not allowable as a cost of patient care. The proportionate part of such interest applicable to assets used for patient care is an allowable cost.

Examples of fixed assets which might be purchased under a single loan agreement could be land, buildings, and equipment used by the provider in furnishing services to patients, and additional land held for future expansion. The land purchased in anticipation of expansion would not be considered related to patient care.

Interest expense for this type of acquisition is allowable as follows:

Total Amount of Mortgage	$500,000
Land, Buildings, and Equipment Related to Patient Care	$400,000
Land Acquired for Future Expansion	$100,000

In the above situation, 80 percent ($400,000 ÷ $500,000) of the mortgage interest would be includable in allowable costs, while 20 percent ($l00,000 ÷ $500,000) would not be includable in allowable costs.

B. Assets Acquired After July l970.--For assets acquired after July l970, see § 203--Interest on Loans in Excess of Asset Value; Acquisition after July l970.

209. INCURRENCE OF DEBT AT AN INTEREST RATE LESS THAN THE PREVAILING INTEREST RATE

When a provider incurs debt at an interest rate which is less than the prevailing interest rate, the reasonable amount paid for obtaining favorable financing is an allowable cost to the extent that the debt was incurred for a purpose related to patient care. However, the amount paid attributable to the favorable financing must be paid to the lender (not related within the meaning of Chapter 10) and the provider must demonstrate, to the satisfaction of the intermediary, that the amount paid was in specific consideration of the favorable financing. The reasonable amount paid would be amortized over the term of the debt.

EXAMPLE 1

Ms. B desires to purchase the assets of Hospital M from Mr. J, a sole proprietor. Ms. B and Mr. J are not related parties within the meaning of Chapter 10. Ms. B, in seeking financing for the purchase, finds that the lowest commercial loan rate that she can obtain for the purchase from any of five local banks is 14 percent. Mr. J offers to finance the purchase at 12 percent if Ms. B pays an additional amount equal to 80 percent of the difference between the interest expense that would have been incurred at 14 percent and the interest expense that will be incurred at 12 percent. The additional amount paid for the favorable financing is documented in the sales agreement. The additional amount paid may be considered an additional cost of financing and may be ratably amortized over the life of the loan.

EXAMPLE 2

Corporation A and Corporation B, unrelated proprietary health care chain organizations, desire to effect a statutory merger, with Corporation A as the survivor. Certain of the assets of Corporation B are encumbered by mortgages that will be assumed by Corporation A as part of the merger. Due to the age of the mortgages, the fixed interest rates that they bear are lower than prevailing interest rates for similar mortgages. The pro form a financial statements presented to the shareholders of Corporation A in preparation for approving the merger show that, included in the consideration to be paid to effect the merger, is a reasonable, additional amount in recognition of the favorable financing. This amount is also stated in the documents effectuating the merger. The additional amount paid for the favorable financing, although reasonable and documented, may not be considered an additional cost of financing and may not be included in the allowable cost of Corporation A providers because it was not paid to a lender (the banks holding the mortgages) as required by §202.3, but rather, was paid to Corporation B shareholders.

2l0. INTEREST ON NOTES

A note is the contractual evidence given by a borrower to a lender that funds have been borrowed and which states the terms for repayment. Interest on notes is allowable as a cost in accordance with the terms of the note. Frequently, a note is issued as an instrument evidencing a loan which may have a term running several years. The interest on such a loan is incurred over the period of the loan. Under the accrual method of accounting, the interest cost incurred in each reporting period is an allowable cost in the applicable reporting period.

If, under the terms of the loan, the interest is deducted when the loan is made (discounted), the interest deducted should be recorded as prepaid interest. A proportionate part of the prepaid interest is allowable as cost in the periods over which the loan extends.

2l2. INTEREST ON BONDS

A bond is an instrument used by both corporations and government entities to borrow funds, usually for long-term capital requirements. A bond is evidence of a liability and bondholders are assured of repayment at some future dates. The terms of the bond are stated in the bond indenture and interest is usually stated as a fixed rate payable in periodic payments such as semi-annually. Interest on bonds is an allowable cost in accordance with the terms of the bond indenture, to the extent that the interest relates to bond proceeds used either to acquire assets for use in patient care activities or to provide funds for operations related to patient care.

212.1 Bond Discount and Expenses.--Where bonds are sold at a price below par or face value, the difference between par and selling price represents the amount of discount. Bond discount is, in effect, an adjustment of the interest rate, a premium which the issuing company allows to the purchaser to induce him to buy the bonds at the interest rate stated for the bonds. The discount is considered additional interest expense paid in advance and, therefore, is includable in allowable cost. The discount, together with any expense related to the issue, is amortized over the period from the date of sale to the date of maturity of the bonds. Amortization may be made on the straight-line method or by the effective interest method, whichever is customarily used by you.

Bond expense is the cost of floating a bond issue. Usually, it is made up of legal, accounting, appraisal and engineering fees, registration and printing of the bonds.

212.2 Bond Discount and Expenses Treated Separately.--Bond discount and expense may be recorded in the same account or in separate accounts. In either event, they are treated as described in §214.1. If the discount and expense are recorded in separate accounts of your facility or are separately identifiable, the bond discount allowable in the reporting period is interest expense; the allowable bond expense is considered as other costs.

For example, if you issue 5 percent, 20-year debentures in the amount of $1,000,000, and the bonds are sold at $980,000 with expenses of issuing of $10,000, your accounting records indicate:

Cash (Dr) $970,000		
Unamortized Bond Expenses (Dr)	$ 10,000	
Unamortized Bond Discount (Dr)	$ 20,000	
Bonds Payable (Cr)	$1,000,000	
Annual Allowable Costs are:		
Bond Interest (5% of $1,000,000)	$ 50,000	
Amortized Bond Discount (1/20 of $20,000)		$ 1,000
Total Interest Costs $ 51,000		
Amortized Bond Expenses (1/20 of $10,000)		$ 500
Total Allowable Costs $ 51,500		

213. INTEREST ON ZERO COUPON BONDS

The zero coupon bond is sold or purchased at a price substantially below face value. Generally, as the period of time until the maturity date increases, the amount at which the bond is sold or purchased, expressed as a percentage of the maturity value, will decrease. This bond is distinguishable from other bonds which may be sold or purchased at a price below par or face value, with the discount representing in effect an adjustment to the interest rate (generally described in §212). With a zero coupon bond, the difference between the purchase price and the value payable at redemption or maturity reflects, in fact, the actual amount of interest. The issuer does not make any interest payments prior to maturity; therefore, no demands are made on current cash requirements. Attractive features of this bond to the purchaser include:

- the need for only a small initial investment to purchase a large and certain future value and

- knowledge at the time of purchase of exactly how much the investment grows in a certain period of time.

For transactions occurring prior to 02/22/91, you were permitted to use the cash basis or accrual basis for reporting interest expense/income on zero coupon bonds as long as the treatment of the interest expense and interest income was the same. That chosen treatment will continue to be recognized until the bond either is called or reaches maturity. Effective with transactions occurring (issuance/purchase of zero coupon bonds) on or after (02/22/91, interest expense/income must be reported on the accrual basis as described below.

A. Interest Expense.--Where you issue zero coupon bonds for a purpose related to patient care, allowable costs must include the accrual of interest expense for your cost reporting period calculated under the effective interest method set forth in §213.1. The issuance of zero coupon bonds in an advance refunding of debt is further governed by guidelines in §233.

B. Interest Income.--Where zero coupon bonds are purchased by you (or, in the case of an advance refunding, by a trust on your behalf), with funds generated from patient care activities, investment income must include the accrual of interest income for your cost reporting period calculated under the effective interest method set forth in §213.1. Such accrued interest income must be offset against allowable interest expense in accordance with §202.2. The purchase of zero coupon bonds from proceeds of advance refunding of debt is further governed by guidelines in §233.

213.1 Effective Interest Method.--Once the actual rate of interest is determined, you must calculate the interest expense/income for your cost reporting period under the accrual basis using the effective interest method. This method recognizes the actual accrual of interest expense/income for each interest computation period (as specified by the bond instrument) throughout the life of the bond to maturity. Under this method, a constant effective yield rate is determined and applied to the book value (outstanding loan balance including prior accrued interest) of the investment at the beginning of each period to determine the total interest for the period. If the interest computation period involves portions of more than one cost reporting period, the amount of interest for that computation period should be apportioned to each cost reporting period based on time. Following is an example of the computation of interest using the effective interest method:

Facts:

- Life of zero coupon bond: 15 years
- Value at maturity: $50,000
- Bondholder pays $6,996 for the bond
- Annual interest rate of 13.5506% compounded semi-annually.

From the table below, interest for the first year would be $980.11 ($474.00 plus $506.11).

Col. 1 SIX-MONTH PERIODS	Col. 2 BOOK VALUE BEGINNING OF PERIOD (Col. 2 and 3)	Col. 3 EFFECTIVE INTEREST*	Col. 4 BOOK VALUE END OF PERIOD
1	$ 6996.00	$ 474.00	$ 7470.00
2	7470.00	506.11	7976.11
3	7976.11	540.40	8516.51
4	8516.51	577.02	9093.53
29	43855.94	2971.37	46827.31
30	46827.31	3172.69	50000.00

*Computed by multiplying the book value at the beginning of each period (Col. 2) by 6.7753% (the annual interest rate of 13.5506% / 2 = 6.7753%).

214. BOND PREMIUM

Where bonds are sold at a price above face value, the difference between the face value and the selling price represents the amount of bond premium. It is paid by the buyer of the bonds to the selling organization and is actually an adjustment of the total interest expense which is realized when the bonds are sold. The amortized portion of the bond premium is a reduction of allowable costs.

214.1 Bond Premium Recorded Separately.--Bond premium is recorded as a deferred credit, and amortized proportionately over the life of the bonds. The portion applicable to each reporting period is a reduction of allowable interest costs for the reporting period. Bond premium is recorded separately from bond expenses related to the issuance of bonds. Where bond premium and bond expenses are not separately recorded and identifiable, they are in effect netted and the entire amount allocable to the reporting period is considered as bond expenses.

For example, if you issue 5 percent, 20-year debentures in the amount of $1,000,000 and the bonds are sold at 102 with expenses of issuing of $10,000, your accounting records indicate:

Cash (Dr)	$1,010,000
Unamortized Bond Expenses (Dr)	$ 10,000
Bond Payable (Cr)	$1,000,000
Unamortized Bond Premium (Cr)	$ 20,000
Annual Allowable Costs are	
Bond Interest (5% of $1,000,000)	$ 50,000
*Less Amortized Bond Premium	
(1/20 of $20,000)	$ 1,000
Total Interest Costs	$ 49,000
*Amortized Bond Expenses	
(1/20 of $10,000)	$ 500
Total Allowable Costs	$ 49,500

*In this example, the bond premium and bond expenses are recorded separately and identifiable.

215. RECALL OF DEBT BEFORE MATURITY

This section pertains to a recall of debt before scheduled maturity without the issuance of new debt. For a discussion of the principles of reimbursement pertinent to a repurchase of debt before scheduled maturity accomplished through the use of funds obtained from the sale of other debt securities (advance refunding), see §233, Advance Refunding of Debt.

Costs incident to the recall of debt before the date of maturity are considered debt cancellation costs and are allowable to the extent they are reasonable. Debt cancellation costs include recall penalties, unamortized discounts and expenses, legal and accounting fees, etc. These costs are reduced by any unamortized premiums. Allowable debt cancellation costs are not reduced by any factor representing that portion of the debt life attributable to years before you entered the program.

In determining the reasonableness of the costs of recalling debt before maturity, consideration must be given to the overall financial implications of the recall. The reasonableness of any costs incurred in connection with the recall of debt before maturity must take into account such approvals as may be required by authorized planning agencies.

215.1 Treatment of Debt Cancellation Costs.--When costs incident to debt cancellation plus the actual cost incurred on the debt during your reporting period are less than the amount of interest cost and amortization expense that would have been allowable in that period had the indebtedness not been cancelled, then the cost of debt cancellation, to the extent reasonable, is allowable in the year incurred.

However, when reasonable costs incident to debt cancellation plus the actual cost incurred on the debt during the provider's reporting period exceed the amount of interest cost and amortization expense that would have been allowable in that period had the indebtedness not been cancelled, the maximum allowable cost in that period is the total amount of interest cost and amortization expense that would have been allowable in that period had the indebtedness not been cancelled. The excess is allowed as a cost in the subsequent period (again, to the extent that the amount does not exceed the interest cost and amortization expense that would have been incurred in that subsequent period, and so on, until fully absorbed).

An exception to this limitation is permitted when the debt cancellation costs are less than 50 percent of the amount of interest cost and amortization expense that would have been allowable in that period had the indebtedness not been cancelled, in which case, the full amount will be allowable in the period incurred. For example, assume that the provider's total allowable interest and amortization expense on a bond for a cost reporting period would be $80,000. However, the bond was cancelled after the first 9 months of the provider's cost reporting period. The provider incurred $60,000 actual interest and amortization expense for the first 9 months of the period and an additional $30,000 in bond cancellation costs. Since the $30,000 debt cancellation cost is less than 50 percent of the interest and amortization expense that would have been incurred had the debt not been cancelled, i.e., 50 percent of $80,000 or $40,000, the full amount, i.e., $60,000, plus the $30,000 bond cancellation cost, is allowed in the period incurred.

This policy is effective for all cost reporting periods beginning after December 31, 1976.

Debt cancellation costs are not interest payments and, therefore, should not be reduced by investment income either in the period of cancellation or in subsequent periods.

216. GOVERNMENT BOND ISSUES

Many providers, particularly hospitals, are owned and operated by Federal, State, and local governments. The facilities are constructed or acquired with funds raised by the governmental entity. Governments at all levels, of course, raise funds for operating and capital expenditures by levying taxes and by borrowing through the device of issuing bonds.

216.1 Government Bond Issues for Construction.--Interest costs are allowable on those governmental bond issues specifically designated for the construction or acquisition of a provider's facility but only where the facility is owned by and the provider is controlled by the governmental entity issuing the bonds. Under this principle, "governmental entity" refers to a level of government, i.e., Federal, State, county or city, rather than a department or agency of a level of government. Also, the concept of "controlled" is the same as that explained in Chapter 10, Cost to Related Organizations.

In many instances, governmental bond issues are designated to meet the construction costs for more than one facility. In such cases, the portion of the interest costs on these bonds applicable to a provider facility is an allowable cost where the facility is owned by and the provider is controlled by the governmental entity issuing the bonds.

This section applies only to situations where the governmental entity issuing the bonds is paying the bond interest and does not apply where the provider is actually paying such interest.

216.2 General Purpose Government Bond Issues.--In some cases, the funds used to construct or acquire the governmental facilities are obtained from the general purpose funds of the government owner. Even though a portion of such fund is raised through bond issues, no part of the interest payable on the bonds is allowable as a cost of the provider.

218. INTEREST ON LOANS FROM LENDERS RELATED TO THE PROVIDER

One of the elements required for interest to be "proper" is that the interest be paid to a lender not related through control, ownership, or personal relationship to the borrowing organization. (See Chapter 10 for the definition of control and ownership.) Presence of any of these factors could affect the "bargaining" process that usually accompanies the making of a loan, and could thus be suggestive of an agreement for higher rates of interest or for unnecessary loans. This provision is intended to assure that loans are legitimate and needed, and that the interest rate is reasonable. Exceptions to this general rule are contained in §§218.2 and 220.

218.1 Interest Paid to Partners, Stockholders, and Related Organizations.--Generally, interest paid by the provider to partners (owners), stockholders, or related organizations of the provider is not allowable as a cost. Where the owner uses his own funds in a business, the funds are considered invested funds or capital, rather than borrowed funds. Therefore, when a partner, stockholder, or related organization makes a loan to a provider, and the interest on the loan is not allowable as a cost, the loan is considered as part of the equity capital of the provider. (See Chapter 12, "Return on Equity Capital," §1220.4E.)

218.2 Interest Paid to Partners, Stockholders, and Related Organizations on Loans Made Prior to July 1, 1966.--There is an exception to the general rule stated in §218.1. It applies where interest is paid to a partner (owner), stockholder, or related organization on loans made before July 1, 1966, provided that the terms and conditions of payment of such loans have been maintained in effect without modification after June 30, 1966. Interest on such loans made before July 1, 1966, is allowable as a cost.

218.3 Owner(s) of Provider Institution on the Board of Directors of Lending Institutions.--Owners of providers may sometimes serve as members of the Board of Directors of a bank or other financial institution which lends money to the provider. A determination as to whether a personal relationship or control exists between the provider and lending institution within the meaning of §218 will be based on the facts and circumstances of each case.

219. ACCOUNTS RECEIVABLE FINANCING

In accounts receivable financing, the intermediary must first determine if the arrangement represents a sale of receivables or if it is a loan. If it is a loan, the interest incurred on the loan is an allowable expense if it is necessary and proper as defined in §§202.1, 202.2 and 202.3. The interest on the loan is the discount on the advance on the receivables (e.g., 10 percent where a provider receives 90 cents on the dollar).

If the intermediary determines that the arrangement is a sale, the costs associated with the sale are not allowable expenses. The provider has opted to receive payment prior to collection on the accounts.

To the extent the provider uses the funds obtained from the financing arrangement to invest in other than its patient care operations, the investment income must be offset against the provider's interest expense. (See §202.2.)

With regards to accounts receivable financing, note that, except as specified in 42 CFR 424.73, Medicare does not pay amounts that are due a provider to any other person under assignment, or power of attorney, or any other direct payment arrangement.

220. INTEREST PAID TO THE MOTHER HOUSE OR OTHER GOVERNING BODY OF A RELIGIOUS ORDER

Providers owned and operated by members of religious orders often obtain funds through loans from the Mother House or Governing Body of the religious order. Where there is a contractual agreement for the payment of interest, and for the eventual repayment of the loan, the interest expense is allowable as cost provided the interest is applicable to the period after the certification of the institution as a provider. Interest expense incurred during a reporting period must be paid within the succeeding reporting period.

226. FUNDED DEPRECIATION

Funding of depreciation is the practice of placing funds, including nonborrowed bond reserve and sinking funds, in a segregated account(s) for the acquisition of depreciable assets used in rendering patient care or for other capital purposes related to patient care. Other capital purposes include capital debt liquidation, such as principal payments for bonds and mortgages and nonborrowed bond reserve and sinking funds to the extent used for a capital purpose, provided they meet all the requirements of §§226ff. Funds deposited in the funded depreciation account must be placed in readily marketable investments of the type that assures the availability and conservation of the funds. Income earned on investments which do not meet this condition must be offset against allowable interest expense.

Although funding of depreciation is not required, it is strongly recommended that providers use this mechanism as a means of conserving funds for acquisition of depreciable assets as described above. The following provisions apply to funded depreciation.

A. Approval.--The action to fund depreciation must be approved by the appropriate managing body of the provider, such as the Board of Trustees or the Board of Directors, in accordance with the needs and objectives of management. As such needs and objectives change, action could be taken in some situations by the managing body to use all or part of the funds in the funded depreciation account for a purpose other than the acquisition of the provider's depreciable assets used to render patient care. The provisions of §226.4 are applicable to those situations.

B. Provider's Records.--The fund or funds must be clearly designated in the provider's records as funded depreciation accounts.

C. Restrictions.--Funded depreciation (total market value of fund) must be available (unless contractually committed as noted below) on an as needed basis for the acquisition of the provider's depreciable assets used to render patient care, or for other capital purposes related to patient care. Loans made from funded depreciation do not alter the requirement that funded depreciation must be available.

Funds are considered available unless committed, by virtue of contractual arrangements, to the acquisition of depreciable assets used to render patient care, or to other capital purposes. Borrowing for a purpose intended by funded depreciation is unnecessary to the extent funded depreciation is available. Thus, interest expense for borrowing up to the amount of available funded depreciation is not an allowable cost.

EXAMPLE: A provider has available $1,500,000 in a funded depreciation account when it decides to construct a $3,500,000 addition to its present facility. If the provider borrows $3,500,000 to finance this capital improvement, the interest expense incurred on the borrowed funds equal in amount to the funded depreciation amount ($1,500,000) would be unallowable.

D. Investment or Transfer.--When a provider invests or transfers the assets of the fund to a home office of a chain organization or to the Mother House or governing body of a religious order or to other related parties, these assets shall be treated as the provider's fund and are subject to all the provisions of §§226ff.

226.1 Interest Paid on Loans from Funded Depreciation.--When the general fund of the provider borrows from the funded depreciation to obtain working capital for normal operating expenses to render patient care, interest incurred by the general fund is an allowable cost. The "necessary and proper" requirements apply to such loans. However, when the general fund of the provider borrows from funded depreciation to acquire depreciable assets to render patient care, interest paid by the general fund to the funded depreciation account is not an allowable cost. Providers are expected to use the funded depreciation for that purpose.

Funding of depreciation from general funds will not be recognized to the extent of any working capital loans the depreciation fund has outstanding and due from the general fund at the time of deposit. Deposits of general funds into the funded depreciation account must be first applied to reduce loans outstanding from the funded depreciation account to the general fund. Until such loans are repaid in full, general funds deposited in the funded depreciation account will be considered as repayments on the loans and, therefore, any subsequent interest expense of the general fund to the extent of the repaid loans is not allowable.

226.2 Interest or Other Income Earned by the Funded Depreciation Account.--Where the provider funds depreciation, it is expected that money in the fund will be invested to earn revenues. Investment income earned by the funded depreciation account attributable to cumulative allowable depreciation expense funded in periods either before or after the provider's participation in the Medicare program is not a reduction of allowable interest expense, provided such investment income is deposited in and becomes part of the funded depreciation account.

226.3 Deposits in the Funded Depreciation Account.--The provider's cumulative deposits in this account cannot exceed its total cumulative allowable depreciation expense (not including gains or losses on the depreciation of depreciable assets and recapture of accelerated depreciation) from the date of acquisition of all provider depreciable assets used to provide patient care services under the Medicare program, including periods before and after the provider's participation in the Medicare program. (See Chapter I.) Hence, funding of such amounts is permitted even though depreciation expense applicable to a period prior to the provider's participation in the program is not an allowable cost. If the total deposits do not exceed total cumulative depreciation expense of assets used to provide services under the Medicare program at the time of the deposit, the provisions of §§226.1 and 226.2 apply. Total cumulative allowable depreciation expense must not be confused with the balance sheet valuation account, accumulated depreciation. Total allowable depreciation expense is computed by totaling all depreciation expense incurred on all assets used to provide services under the Medicare program. This total is compared with total deposits (excluding income earned) to the funded depreciation account. Investment income from such funded depreciation deposits retains its identity and becomes a part of the funded depreciation fund if deposited in the funded depreciation account at the time of receipt by the provider. Such investment income remains funded depreciation even if the deposit of such funds results in a fund balance in excess of total cumulative allowable depreciation expense. If the provider makes "extra" deposits of funds in excess of the accumulated depreciation, the provisions of §§226.1 and 226.2 do not apply. Thus, any income earned by such "extra" deposits is applied as a reduction of interest expense.

Deposits to the funded depreciation account must remain for 6 months or more to be considered as valid funding transactions and to permit application of §§226.1 and 226.2. Deposits of less than 6 months' duration are not eligible for the benefits of those sections. Investment income earned prior to elapse of the 6-month period will not be offset unless the deposits are actually withdrawn during this period. A loan to the general fund is considered a withdrawal for this purpose.

226.4 Withdrawals from the Funded Depreciation Account.--Because deposits in the funded depreciation account may be used for a variety of purposes, the following provisions apply:

A. Withdrawals for the Acquisition of Depreciable Assets Used to Render Patient Care or Other Patient Care-Related Capital Purposes and for Investments.--These withdrawals must be made on a first-in, first-out basis. The oldest deposits must be withdrawn first. These withdrawals must be related to the acquisition of such assets of the same provider maintaining the fund from which such withdrawals are made. The program does not recognize the use of one provider's funded account to acquire patient care assets of another provider because a funded depreciation account is limited to the use of the provider maintaining it.

B. Withdrawals for Other Than the Acquisition of Depreciable Assets Used to Render Patient Care or for Other Patient Care-Related Capital Purposes and Investments.--These withdrawals must be made on a last-in-, first-out basis. The latest deposit made must be considered the deposit withdrawn for these purposes. For example, if a loan is made to the general fund on February 1, 1980, and deposit of an equal or greater amount is in the funded account since January 1, 1980, the withdrawal will be considered to be made from the January 1 deposit and interest, if any, paid by the general fund is not allowable as a cost, because the funds were not on deposit for at least 6 months. (See §226.3.)

When funded depreciation is used by the provider for other than (1) the acquisition of depreciable assets used to render patient care; (2) investments; (3) loans to the general fund for current operating costs related to patient care; or (4) other capital purposes as described in §226, the investment income earned on these funds while on deposit in the funded account shall be used to reduce allowable interest expense incurred during all cost reporting periods subject to reopening.

C. Priority of Withdrawals.--Available funded depreciation must be withdrawn and used before resorting to borrowing for the acquisition of depreciable assets or other capital purposes, except that, when available funded depreciation is insufficient to cover the total cost of a major construction project and borrowing is necessary (see §202.2), all available funded depreciation need not be withdrawn and applied to construction cost prior to borrowing. Because it is frequently difficult to time a bond offering or other borrowing to coincide with the exhaustion of available funded depreciation, it is sufficient if available funded depreciation is contractually committed to and expended during the course of construction.

226.5 Money Borrowed to Fund Depreciation.--Borrowed bond reserve and sinking funds are not allowable as funded depreciation, but the interest on such borrowing is allowable subject to the requirements of §202.1, and income earned by the borrowed funds is applied as a reduction of interest expense. (Reference §202.2.)

228. QUALIFIED PENSION FUND

Generally, a qualified pension plan under Internal Revenue Service regulations is a plan established and maintained by a provider primarily to provide systematically for the payment of definitely determinable benefits to the provider's employees for a period, usually for life, after retirement. The trust instrument establishing the plan would provide for a fund to be accumulated by the trust in accordance with the plan. Deposits of cash or other liquid assets are made to the fund in accordance with the pension plan. In the establishment of such pension funds, a trustee relationship is created with you in regard to the deposits into the fund and their use in accordance with the pension plan. The same treatment accorded to deposits of funded depreciation are accorded deposits in the qualified pension fund. (See §§226 to 226.5.)

230. INTEREST EXPENSE OF RELATED ORGANIZATIONS

Where you lease facilities from a related organization and the rental expense paid to the related organization is not allowable as a cost, costs of ownership of the leased facility are your allowable costs. Therefore, in such cases, mortgage interest paid by the related organization is allowable as an interest cost to you. (See Chapter 10, "Cost to Related Organizations," §1008.)

233. ADVANCE REFUNDING OF DEBT

233.1 General.--Advance refunding is a refinancing technique which enables you to replace existing debt prior to its scheduled maturity with new debt. This section does not apply to a recall of debt before scheduled maturity without the issuance of new debt. (See §215, Recall of Debt Before Maturity.) Advance refunding is done for a variety of reasons including achieving a lower interest rate, improving cash flow, removing restrictive covenants, and increasing borrowing capacity. Sections 233.1 - 233.5 are effective for all refundings initiated on or after July 1, 1983. For purposes of this section, the term "initiated" means either (1) an action taken by you which reflects a clear intention to effect the advance refunding (e.g., board resolution empowering the management to proceed with the advance refunding, engagement of an underwriter, application to the debt-issuing authority, etc.), or (2) an official action by the debt-issuing authority reflecting a clear intention to effect the advance refunding.

233.2 Definitions.--For purposes of this section, the following definitions apply:

Refunding Debt.--New debt issued to provide funds to replace the refunded debt immediately or at a specified future date(s).

Refunded Debt.--Debt for which payment immediately or at a specified future date(s) has been provided by the issuance of refunding debt.

Advance Refunding.--A transaction in which refunding debt is issued to replace the refunded debt immediately or at a specified future date(s).

Defeasance Provision.--A provision in the refunded debt instrument that provides the terms by which the debt may be legally satisfied and the related lien (if any) released without the debt necessarily being retired.

Defeasance.--Legal satisfaction of debt under the terms of a defeasance provision.

233.3 Allowable Costs.--When you defease or repurchase debt incurred for necessary patient care through an advance refunding, the revenues and expenses associated with the advance refunding are treated as follows:

A. Debt issue costs on the refunding debt must be amortized over the life of the refunding debt from the date the debt is incurred to scheduled maturity of the debt. (See §§204, 206, 210, and 212.1.)

B. Debt cancellation costs on the refunded debt are allowable as indicated below:

o Redemption expenses and any other miscellaneous expenses (legal fees, initial trustee fees, feasibility studies, stamp fees, printing, etc.) are allowed as paid or accrued (subject to §2305);

o Annual authority and trustee fees are allowed as paid or accrued (subject to §2305);

o Call premiums or penalties are allowable in the period(s) the holders of the refunded debt receive the principal payment. Call premiums or penalties of serial bonds are prorated over the scheduled maturity or recall dates on the basis of the proportionate principal repayments at each date.

C. Unamortized discounts or premiums (reduction of debt cancellation costs) and debt issue costs of the refunded debt must be amortized over the period from the issue date of the refunding debt to the date the holders of the refunded debt receive the principal payment (appropriately prorated in the case of serial bonds as in subsection B).

D. Interest expense on the refunded debt is allowable on the accrual basis, whether incurred by you or by a trust. (See §2305ff.) Similarly, interest expense on the refunding debt is allowable on the accrual basis. The amortized portion of discounts or premiums on the refunding debt is an adjustment to allowable interest expense in accordance with §§212.1 or 214, respectively. The interest income derived from the investment of the proceeds of the refunding debt must be used to offset interest expense in accordance with §202.2, whether this interest income is earned by you directly or through a trust, however, see §2806.1G. If an advance refunding involves a zero coupon bond(s), you must follow the rules set forth in §213ff for the interest expense and interest income.

The effect of the above treatment is to implicitly recognize any gain or loss incurred as the result of an advance refunding over the period from the date the refunding debt is issued to the date the holders of the refunded debt receive the principal payment, rather than immediately. The individual expense elements are the only costs which can be reimbursed in accordance with the above policy.

233.4 Limitation on Recognition of Costs.--As with all costs incurred for funds borrowed, the costs associated with an advance refunding must meet the necessary and proper tests of §§202.2 and 202.3, respectively, as well as the reasonable cost provisions of §2100ff. In addition, sinking funds available for liquidation of the refunded debt must be considered in a determination of necessary borrowing through advance refunding. On occasion, a provider may borrow more than the amount required to advance refund the existing debt. If the additional borrowing is for the acquisition of depreciable assets, existing funded depreciation must be taken into account in determining the necessity of the excess borrowing. Generally, the total net aggregate allowable costs (as described in §233.3) incurred for all cost reporting periods related to the advance refunding cannot exceed the total net aggregate costs that would have been allowable had the advance refunding not occurred. However, in evaluating the necessity, propriety and prudence of an advance refunding, consideration may be given to factors such as cash flow needs or the necessity to remove a restrictive covenant that prevents the provider from borrowing additional funds for an appropriate purpose.

If the provider incurs excess aggregate costs, as described above, the excess costs will be allowable only where the provider can demonstrate to the satisfaction of the intermediary that compelling factors (such as those mentioned above) necessitated the advance refunding. In cases where the provider cannot make such a satisfactory demonstration, the excess costs are unallowable, and the provider's reimbursement would be limited annually to the costs it would have incurred if the old bonds had not been refunded.

233.5 Treatment of Items for Equity Capital Purposes.--All debts, and proceeds of those debts, associated with advance refunding incurred for necessary patient care are includable in the determination of equity capital in accordance with Chapter 12. However, if interest expense is disallowed under the limitation expressed in §233.4, the debt (or unreasonable portion thereof) associated with the disallowed interest expense, as well as the related assets, must be excluded in the determination of equity capital.