Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:FIP:B02
PLR-145136-04
Date:
February 4, 2005

Legend:

Lenders =

=

City =

Dear :

This responds to your request dated August 24, 2004, and subsequent correspondence dated December 1, 2004, submitted by your authorized representatives on behalf of Lenders and a real estate mortgage investment conduit (REMIC) to be formed at a later date, for a ruling that a mortgage loan to be secured by an acute care hospital to be constructed in City and to be insured under a federal program as described below will constitute an obligation principally secured by an interest in real property within the meaning of section 860G of the Internal Revenue Code of 1986 (Code).

FACTS

Lenders are domestic corporations that service and originate hospital loans insured by the Federal Housing Administration (FHA) of the Department of Housing and Urban Development (HUD). Lenders propose to originate a mortgage loan, the proceeds of which will be used to finance the construction of a new acute care hospital to be located in City. The loan will be secured both by the hospital and by certain equipment to be used in the operation of the hospital.

The loan is expected to be insured under an FHA program for acute care hospitals that allows eligible hospitals to enhance the creditworthiness of their indebtedness with insurance backed by the United States government. The program permits hospitals to reduce their mortgage interest rate and facilitates their capital development projects. The program is authorized by section 242 of the National Housing Act. See 12 U.S.C. 1715z-7.

The program requires that lenders obtain an appraisal of the raw land upon which the hospital is to be built that reflects the value of the land as if fully improved (as opposed to the value of the land as-is) by off-site infrastructure needed for the operation of the hospital, such as access to water, power, and adjacent roadways. A fully improved value assumes that the requisite zoning, street improvements and utilities are in place.

Under the program, the amount of a mortgage to be insured is not allowed to exceed 90 percent of the estimated replacement cost of the property or project, including equipment to be used in the operation of the hospital. The mortgage loan will be secured by a first mortgage lien on the entire hospital, including property, plant and equipment.

Lenders have made application to the program on Form HUD 92103-Hosp, Application for Hospital Project Mortgage Insurance (Form 92103). This application requires a listing of all elements of estimated replacement costs for the hospital.

In its review of the application, HUD will determine whether the project meets all program requirements, including a determination of the reasonableness of the estimates of the replacement costs. HUD will also institute a third-party evaluation of market feasibility and financial projections of the hospital. The Department of Health and Human Services (HHS) will also review the application. A letter of approval from HHS is required before HUD will issue a firm commitment for insurance.

When HUD has made a determination, based on its review of the application for mortgage insurance, that the mortgage loan satisfies the requirements of the program, it will provide Lenders with a written firm commitment of insurance for the loan and with a Form 2264 (Hosp.), Replacement Cost and Maximum Insurable Mortgage Hospital Project. The Form 2264 (Hosp.) will set forth the replacement costs for the hospital as approved by HUD. No more than 90 percent of the approved estimated replacement costs can be insured under the program. This firm commitment in accordance with the approved replacement costs set forth on Form 2264 (the “firm commitment”) will constitute a 60-day obligation to insure the loan, and may be extended in HUD’s discretion.

Upon receipt of the firm commitment to insure the loan, Lenders will initiate the process of closing on the construction loan by locking in an interest rate for the loan. If the interest rate on the loan differs from the rate specified in the firm commitment, Lenders will seek an amendment of the firm commitment so that its terms will be consistent with the terms of the loan. At closing, a HUD representative will endorse the note to indicate the existence of the contract of mortgage insurance.

After closing on the construction loan, Lenders will begin to disburse the projected loan amount as the mortgagor incurs expenses. All disbursements will be governed by the categories of replacement costs on Form 2264 and on HUD Form 92441, the Building Loan Agreement. All disbursements will first be approved by HUD.

At the end of the construction period, an accounting firm will conduct a third-party audit to determine the actual costs incurred during construction. If the audit determines that less money was spent than estimated in the firm commitment (as, for example, if construction period interest amounts differ from those estimated owing to the timing of loan disbursements during construction), the permanent loan amount will be reduced as necessary to ensure that it does not exceed 90 percent of the certified replacement costs. After reviewing the third party cost audit, HUD will endorse the note for the full original face amount or in an amount reflecting the appropriate adjusted cost figures, including actual construction period interest. Upon this final endorsement, the insured loan ceases to be a construction loan and becomes a permanent loan.

Lenders intend to sell the permanent loan to a third party who will contribute or sell the loan to a REMIC to be formed at a later date.

LAW AND ANALYSIS

Section 860D(a)(4) of the Code defines a REMIC in pertinent part as an entity substantially all of the assets of which consist of qualified mortgages and permitted investments as of the close of the third month beginning after the startup day and at all times thereafter. Section 860G(a)(3)(A) requires that an obligation be principally secured by an interest in real property to be considered a qualified mortgage.

Section 1.860G-2(a)(1) of the Income Tax Regulations (the regulations) sets forth two tests for determining whether an obligation is principally secured by an interest in real property. Under this regulation, an obligation is principally secured by an interest in real property only if it satisfies either the 80-percent test set out in paragraph(a)(1)(i) or the alternative test set out in paragraph(a)(1)(ii).

Under the 80-percent test, an obligation is principally secured by an interest in real property if the fair market value of the interest in real property securing the obligation was at least equal to 80 percent of the adjusted issue price of the obligation at the time the obligation was originated (or significantly modified, as described in

§1.860G-2(b)(1)), or is at least equal to 80 percent of the adjusted issue price of the obligation at the time the sponsor contributes the obligation to the REMIC. §1.860G-2(a)(1)(i) of the regulations.

Under the alternative test, an obligation is principally secured by an interest in real property if substantially all of the proceeds of the obligation were used to acquire or to improve or protect an interest in real property that, at the origination date, is the only security for the obligation. §1.860G-2(a)(1)(ii) of the regulations.

Lenders seek a ruling that the permanent mortgage loan to be issued by Lenders to finance the construction of a new acute care hospital satisfies the 80-percent test set out in §1.860G-2(a)(1)(i) of the regulations. Because the permanent mortgage loan will be secured by a first mortgage lien on the entire hospital, including property, plant and certain equipment to be used in the operation of the hospital, the determination of the fair market value of the interest in real property securing the permanent mortgage loan for purposes of the 80-percent test requires a determination of (1) the fair market value of the land upon which the hospital is built and (2) the fair market value of the improvements or developments securing the loan that are real property.

(1) The value of the land. Lenders seek a ruling that the fair market value of the land be determined for purposes of the 80-percent test by reference to the appraisal obtained in the course of their application to the HUD program. The appraisal is required by the terms of the HUD program to reflect the value of the land as if fully improved by off-site infrastructure, as described above, and is required to be obtained prior to the time HUD makes a firm commitment to insure the property. Lenders do not propose to reappraise the land at the end of the construction period to determine its fair market value at the time of final endorsement of the permanent loan.

(2) The value of real property improvements. In order to establish the value of the improvements that are real property, Lenders must first identify which program costs are allocable to real property. A number of these costs are clearly identifiable as related to real property, such as the cost of constructing the hospital building. A second group of costs are identifiable as related to personal property, such as the costs of (non-fixture) equipment and furnishings. A third group of costs, such as construction period interest, HUD mortgage insurance premium and fees, and the lender's financing and placement fees, are apportioned between real property and personal property. Lenders use a formula to allocate costs in the third group between real property and personal property that is based on the relative estimated replacement amounts of costs in the first group (real property costs) and costs in the second group (personal property costs).

Lenders seek a ruling that the fair market value of the real property improvements, identified as described in the preceding paragraph, be determined for purposes of the 80-percent test by reference to the actual replacement costs of these

improvements, as determined by the third party cost audit conducted at the end of the construction period and prior to HUD endorsement of the permanent mortgage loan.

As the insurer of hospital mortgage loans, HUD has a significant interest in establishing the value of all property, including plant, land, and equipment, that forms the security for the loans it insures. The rigorous and highly specific requirements of the HUD program are designed to assure an accurate assessment of the value of all components of the security for the loans HUD insures. For this purpose, HUD requires the use of an appraised land value determined prior to the time it issues its firm commitment to insure the mortgage loan. It requires the use of a value for the real property improvements, however, that is established at a later time. The value of the real property improvements is set by reference to the actual replacement costs of these improvements, as audited and certified subsequent to construction. The appraised land value, determined prior to construction, and the actual replacement costs of the real property improvements, determined after construction, are the values used by HUD in determining the actual loan amount of the permanent mortgage loan.

Taking into account these facts and circumstances, we rule that a mortgage loan on an acute care hospital insured by HUD pursuant to section 242 of the National Housing Act will constitute an obligation principally secured by an interest in real property under section 860G(a)(3) of the Code and §1.860G-2(a)(1)(i)(A) of the regulations, if the sum of (1) the value of the land securing the mortgage loan, as determined by appraisal conducted as part of the process of obtaining a firm commitment by HUD to insure the mortgage loan, and (2) the value of real property improvements securing the mortgage loan, as determined by their actual replacement costs as audited and certified after construction of the hospital, equals at least 80 percent of the adjusted issue price of the permanent loan amount approved by HUD at final endorsement of the permanent mortgage loan.

Except as specifically ruled upon above, no opinion is expressed or implied regarding the federal tax consequences of the described transaction. No opinion is expressed as to whether a REMIC that holds a mortgage loan described in the preceding paragraph otherwise qualifies as a REMIC under sections 860A through 860G of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the federal income tax return of the REMIC that holds the permanent mortgage loan described in this letter.

A copy of this letter is being forwarded to your authorized representatives pursuant to a power of attorney on file in this office.

Sincerely,

William E. Coppersmith
William E. Coppersmith
Chief, Branch 2
Office of the Associate Chief Counsel
(Financial Institutions & Products)