

Tax Developments Affecting Health Care Organizations



Moderator

Mark Kadzielski, Los Angeles, CA

Panelists

Ellen McElroy, Washington, DC

Clayton Garrett, Washington, DC

April 15, 2014



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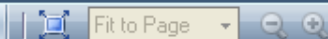
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Pepper Hamilton LLP
Attorneys at Law



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Moderator: Mark A. Kadzielski



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- Partner and head of the Health Care Services practice of Pepper Hamilton LLP, resident in the Los Angeles office.
- Represents hospitals, medical staffs, managed care enterprises, and institutional and individual health care providers throughout the United States. His work includes government regulatory investigations, contracting issues, credentialing, peer review, licensing, medical staff bylaws, joint commission accreditation and Medicare certification.
- Has prepared more than 200 sets of medical staff bylaws and has handled numerous peer review hearings and appeals, including litigation in many courts.

Speaker: Ellen McElroy



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- Partner with Pepper Hamilton LLP, resident in the Washington D.C. office.
- Focuses on a broad variety of corporate tax issues, primarily accounting method considerations
- Regularly advises clients on the proper tax treatment of costs associated with tangible property, (including the treatment of repair costs), intangible property (including acquisition costs and recovery), and corporate transaction costs. With respect to corporate transaction costs, she advises clients regarding various corporate transactions, including both acquisitive and divisive transactions, both strategic and private equity transactions
- Represents clients before the IRS, including representation at the IRS National Office with private letter rulings and technical advice.

Speaker: Clayton Garrett



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- Project Manager, resident in the Washington, D.C. office
- Focuses on a broad variety of corporate tax issues, including corporate tax and state and local tax issues
- Regularly advise on the tax treatment of corporate transaction costs.



Agenda

- Income recognition issues associated with bundled payment arrangements
- Income recognition related to electronic health records
- Developments involving the nonaccrual experience method of accounting for bad debts
- Issues faced by healthcare providers with respect to the tangible property regulations

Bundled Payments



Bundled Payments – Overview

- In a typical bundled payment arrangement, a healthcare provider receives a single bundled payment and then distributes individual payments to specialists and other care providers
 - Example: Hospital receives payment for hip replacement surgery and then distributes to the anesthesiologist, surgeon, medical device company, etc., to cover the costs of various services
- Traditionally, Medicare and Medicaid paid each provider separately for services performed in the course of treatment, producing fragmented care and requiring coordination among providers

Bundled Payments – Overview

- Bundled payments were initially prompted by the Patient Protection and Affordable Care Act (P.L. 111-148), which contained numerous provisions intended to transform the delivery of health care services
- Such provisions included coordinated care through Accountable Care Organizations (ACOs) and bundling payments to providers
- Bundled payments are believed to align incentives for providers, allowing for increased efficiency and quality of care improvement

Bundled Payments – Overview



- Centers for Medicare and Medicaid Services (CMS) recently implemented a bundled payment initiative to study various bundled payment models
- The CMS study has been developed to test various payment and service models to reduce costs for Medicare, Medicaid, or Children’s Health Insurance Program, as well as enhancing quality of care
 - Three year initiative
 - Four Models of Care, each beginning at different intervals
 - Model 1-Retrospective Acute Care Hospital Stay Only
 - Model 2-Retrospective Acute Care Hospital Stay plus Post-Acute Care
 - Model 3-Retrospective Post-Acute Care Only
 - Model 4-Prospective Acute Care Hospital Stay Only

Bundled Payments - Overview



- CMS issued an advance notice of proposed rulemaking soliciting comments regarding payment methodologies associated with Durable Medical Equipment and Enteral Nutrition furnished under competitive bidding programs
- Considering monthly bundled payments based on supplier bids as a way to simplify the current program, improve beneficiary access to items and services, and contribute to greater cost savings

Bundled Payments – Tax Issues



- An accrual basis taxpayer recognizes income and deductions under the “All Events Test” when:
 - All events have occurred that fix the right to receive, or fix the fact of the liability;
 - The amount can be determined with reasonable accuracy; and
 - For liability and expense purposes, economic performance has occurred.
- Under the AET, questions arise regarding when and whether bundled payments must be recognized

Bundled Payments – Tax Issues

- Must companies recognize income on the entire amount received?
 - If not, is the company considered a flow-through for purposes of passing payments to others?
 - If so, when is it required to include the amounts as income, and when would a deduction be permitted for the payments made to other providers?
- What amount is properly included within income?
 - Contractually agreed upon amount or the standard charges?
- How are co-pays reflected in the company's income?
- How are income issues affected when the payments are delivered to hospital employees as opposed to independent contractors?

Implementation of Electronic Health Records



Electronic Health Records - Overview



- The American Recovery and Reinvestment Act of 2009 created Medicare and Medicaid incentive payments for certain eligible providers implementing Electronic Health Records (“EHR”)
 - Incentive program began in 2011 and lasts through 2016
 - Still accepting applications to participate in the incentive programs
 - The last year to begin participation in the program is 2014
- Receipt of incentive payments requires a demonstration that a provider has established “meaningful use” of EHRs
 - Meaningful use is based on various objectives and milestones within three different implementation stages
 - Stage 1 examples – recording patient demographics and chart changes in vital signs, implementing drug-drug and drug-allergy interaction checks, and maintaining active medication (and medication allergy) lists
 - Payments are received on a rolling basis after meaningful use has been met for the reporting period



- There is a discrepancy between the book and tax treatment of payments received for implementing EHR
 - For book purposes, companies generally defer income recognition on payments received under the gain contingency model, which requires:
 - all significant contingencies to be resolved prior to the recognition of revenue
 - deferral of revenue recognition until after the company has successfully complied with criteria during the entire reporting period
 - Gain contingency for Medicaid
 - recognition occurs when meaningful use criteria are met and formal state acceptance is documented
 - Gain contingency for Medicare
 - recognition occurs when Medicare fiscal year ends during which meaningful use is demonstrated, and cost report information used to determine the final reimbursement amount is known



- For tax purposes, it is unclear when the revenue must be recognized and whether these payments qualify for income deferral
- Unfortunately, no tax theory supports deferring income as long as it's deferred under a gain contingency approach
- When are the payments properly recognized as income?
 - All Events Test suggests income should be accrued when meaningful use is established
 - Do the payments qualify for income deferral under Rev. Proc. 2004-34?

Nonaccrual Experience Method



Nonaccrual Experience Method

- NAEM permits taxpayers with services-related income to avoid accrual of income expected to be uncollectible based on previous experience
 - This method is limited to services related income and cannot be used for amounts owed from activities such as lending money, selling goods, or acquiring receivables
- The procedure for establishing experience under the NAEM was subject to significant IRS challenge
- Rev. Proc. 2011-46: NAEM safe harbor resolved many issues
 - Amount excluded from income is determined as 95% of the taxpayer's allowance for doubtful accounts reported on its applicable financial statement
 - Taxpayer may generally use any reasonable method to determine the portion of its applicable financial statement allowance attributable to current year receivables

Nonaccrual Experience Method

- Tax reform is likely in 2015
 - Recent proposals would limit certain service organizations from using the cash method of accounting, thus requiring more taxpayers to use the accrual method of accounting
 - Proposals place greater emphasis on methods of accounting for bad debt
 - If enacted, more taxpayers would have to consider the use of NAEM
- Income Tax Reform Proposals by Rep. Camp.
 - Current proposal generally retains NAEM
 - Camp proposal makes limited revisions and moves rules from § 448 to § 451

Tangible Property Regulations



Tangible Property Regulations – Overview

- The IRS has recently issued a sweeping set of regulations affecting all taxpayers that acquire, produce, or improve tangible property (e.g., plants, buildings, equipment, and machinery), including costs of improving and/or disposing of such property
- Regulations released by IRS and the Treasury Department on September 13, 2013
- Final regulations (TD 9636)
 - Provide guidance on whether particular costs are deductible repair costs or nondeductible capital expenditures
 - Allow immediate deductions for certain de minimis acquisitions
- Proposed Regulations (REG-110732-13)
 - Allow taxpayers to recover costs from a partial disposition of an asset (e.g., cost of a building's roof may be deducted when it is replaced)

Tangible Property Regulations – Overview



- Rules require most companies to analyze and consider:
 - when and how they will comply with guidance
 - establish business procedures for implementation and compliance
 - filing an application with the IRS (Form 3115) to change various methods of accounting for compliance purposes, which requires an income adjustment in the year of change
- Effective Dates
 - Taxpayers may elect to implement the Regulations in 2012, 2013, or 2014.
 - However, rules must be implemented for tax taxable years beginning on or after January 1, 2014

Tangible Property Regulations - Overview



- Significant aspects of the Tangible Property Regulations for Health Care Providers
 - Rules provide guidance for determining whether costs associated with improvements may be capitalized or deducted
 - Rules provide several safe harbor elections that should be considered
 - for acquisitions
 - for routine maintenance
 - for small taxpayers
 - Rules allow partial loss on disposition



– De Minimis Safe Harbor Election

- Safe harbor permits taxpayers to deduct amounts up to \$5,000 per invoice/per item (e.g., devices, equipment, computers, etc.)
- Taxpayers with applicable financial statement (AFS) - must have a written accounting policy which expenses amounts incurred for property with useful life of 12 months or less, for property costing less than a threshold amount
 - also extends to taxpayers without AFS - \$500 threshold

Tangible Property Regulations – Improvements



- Standard: must capitalize amounts paid to improve a “unit of property”
- Determination of a Unit of Property
 - Functional interdependence
 - Building and structural components are treated as a single unit
 - 8 separate building systems (HVAC, Plumbing, Electrical, etc.)
- Unit of property is improved if amounts are paid resulting in:
 - Betterments to the unit of property
 - Restoration to the unit of property
 - Adaptation of the unit of property to a new or different use
- These issues arise regularly with equipment, facilities, or building maintenance, repairs, or renovations
- For healthcare companies with regular updates to reflect use by the public, regulatory requirements, and technological advancements, the improvement rules are critical

Tangible Property Regulations – Other Safe Harbor Elections



- Routine Maintenance Safe Harbor
 - Safe harbor election from capitalization requirement
 - Routine maintenance – generally, expenditures incurred by a taxpayer on activities expected to keep a unit of property in its ordinarily efficient operating condition.
 - Buildings – reasonably expected to be performed more than once during 10-year period
 - Once the reasonable expectation conditions are met, routine maintenance can be performed at any time and does not have to be performed more than once
- Small Taxpayer Safe Harbor
 - Safe harbor election from capitalization requirement
 - Includes buildings (owned or leased) with an unadjusted basis of \$1 million or less, and taxpayers with average gross receipts of \$10 million or less.
 - Unavailable if total repairs, maintenance, and improvements exceed \$10,000 or 2% of the unadjusted basis of the building

Tangible Property Regulations – Dispositions



- Dispositions
 - Includes sale, exchange, retirement, physical abandonment, destruction, and a transfer to supplies, scrap, or similar account
 - Asset disposed of includes building, cooperative, or condominium, rather than individual structural components
 - Partial dispositions permitted
 - Allow taxpayers to claim a loss upon the disposition of a structural component without identifying the component as an asset before

Tangible Property Regulations – Implementation Guidance



- Rev. Proc. 2014-16
 - To change accounting methods under these regulations, taxpayers must detail the change being made, relevant facts, legal support, and specify the provision of the Regulations to which the change applies
 - Permits a modified § 481(a) adjustment for certain method changes
 - Eliminates requirement that a method change be accompanied by concurrent § 263A uniform capitalization accounting method change
 - may only be available on a limited basis

Tangible Property Regulations – Implementation Guidance



- Rev. Proc. 2014-17
 - Procedures for complying with disposition rules of the Regulations
 - Allow taxpayers to make a late partial disposition loss election and/or revoke a GAA election via accounting method change
 - Late partial disposition elections must be made for a tax year beginning on or after January 1, 2012, and before January 1, 2014
 - calendar year taxpayer must make this change no later than extended due date of the 2013 tax return
 - Future years – partial disposition elections will be made on the return for the year in which the disposition/retirement occurs
 - Also provides guidance for revocation of GAA
 - include late elections made through automatic method changes and timely elections made on 2012 return
 - Only allowed for limited time

Questions & Answers



Firm Facts

- Established in 1890
- More than 500 lawyers
- Thirteen offices in seven states (PA, NJ, DE, NY, MA, MI and CA) and the District of Columbia
- National and international practice (including active client matters in Europe, the UAE, the Near East, the Far East, South America, Canada and other parts of the world)

Practice Breakdown





- Team of 13 attorneys
- Assists clients with proactive tax planning
- Integrally involved in the structure and formation of partnerships
- Significant experience in private equity funds, hedge funds, mezzanine funds and their investments

Federal Tax
Structuring
Tax Controversy
Financing
Merger and Post-Merger Services
State and Local Tax
Tax Structuring and Tax Planning
Net Operating Loss Analysis
Tax Due Diligence
Internal Restructuring
Property Tax Planning
Tax Controversy

National Health Care Services Practice

- Team of 52 attorneys
- Help health care clients overcome challenges and meet business goals
- Proficient in complex regulatory issues under federal and state laws
- Leverage experience and skill of nearly 500 colleagues in more than 90 related areas of the law

Mergers and Acquisitions
physicians, hospitals, other health care
related organizations and companies

Organizational Structuring

Pharmacy Issues
transactions, regulatory

Residential Elderly / Homebound
skilled nursing care, housing/homecare

Physician / Hospital Relations

Wellness / Benefits
employer primary care centers

Clinical Research

Innovative Medical Devices

Health care IT
privacy, security, meaningful use,
breach, mobile, telehealth

Labor and Employment

Our Locations



Pepper has expanded from its Philadelphia origins to 13 locations.





**For more information,
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