

## 100. GENERAL

The principles of reimbursement for provider costs provide that payment for services should include depreciation on all depreciable type assets that are used to provide covered services to beneficiaries.

This includes assets that may have been fully (or partially) depreciated on the books of the provider but are in use at the time the provider enters the program. The useful lives of such assets are considered not to have ended and depreciation calculated on a revised extended useful life is allowable. Likewise, a depreciation allowance is permitted on assets that are used in a normal standby or emergency capacity.

The three methods of prorating the cost of depreciable assets are: straight line, declining balance, and sum of the years' digits. For assets acquired after July 1970, however, the use of an accelerated method of depreciation is limited to a declining balance method not to exceed 150 percent of the straight-line rate under the criteria stated in §116C. The depreciation method used under the Medicare program for an asset need not correspond to the method used by a provider for non-Medicare purposes.

## 102. PRINCIPLES

An appropriate allowance for depreciation on buildings and equipment is an allowable cost. The depreciation must be: (a) identifiable and recorded in the provider's accounting records; (b) based on the historical cost of the asset as defined in §104.10 or, in the case of donated assets, the lesser of the fair market value or the net book value at the time of donation (see §114.2); and (c) prorated over the estimated useful life of the asset using an allowable method of depreciation as described in §116.

Depreciation on assets being used by a provider at the time it enters into the title XVIII program is allowed. This applies even though such assets may be fully or partially depreciated on the provider's books.

For all assets acquired before 1966, the provider, at its option, may choose an allowance for depreciation based on a percentage of operating costs. The operating costs to be used are the lower of the provider's 1965 operating costs or the provider's current year's allowable costs. The percent to be applied is 5 percent starting with the year 1966-67, with such percentage being uniformly reduced by one-half percent each succeeding year. The allowance based on operating costs is in addition to a regular depreciation on assets acquired after 1965. However, when the optional allowance is selected, the combined amount of such allowance on pre-1966 assets and the straight-line depreciation on assets acquired or rented after 1965 may not exceed 6 percent of the provider's allowable cost for the current year.

Depreciation is allowed on assets financed with Hill-Burton or other Federal or public funds.

## 104. DEFINITIONS

Depreciation is that amount which represents a portion of the depreciable asset's cost or other basis which is allocable to a period of operation. The amount of depreciation is determined by the provider's method of depreciation accounting.

The American Institute of Certified Public Accountants defines depreciation as a process of cost allocation:

"Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of

valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year."

104.1 Depreciable Assets.--Assets that a provider has an economic interest in through ownership (regardless of the manner in which they were acquired) are subject to depreciation. Generally, depreciation is allowable on the assets described below when required in the regular course of providing patient care. Assets which a provider is using under a regular lease arrangement would not be subject to depreciation by the provider. (See §110 on lease-purchase and sale-lease-back agreements.)

In general, assets subject to depreciation are described in the AHA Chart of Accounts for Hospitals, M-58, 15M-8/66-183305, and for the most part are also subject to depreciation for Medicare purposes. However, see the treatment of minor equipment as described below.

104.2 Buildings.--Building includes, in a restrictive sense, the basic structure or shell and additions thereto. The remainder is identified as building equipment.

104.3 Building Equipment.--Building equipment includes attachments to buildings, such as wiring, electrical fixtures, plumbing, elevators, heating system, air conditioning system, etc. The general characteristics of this equipment are: (a) affixed to the building, and not subject to transfer; and (b) a fairly long life, but shorter than the life of the building to which affixed. Since the useful lives of such equipment are shorter than those of the buildings, the equipment may be separated from building cost and depreciated over this shorter useful life.

104.4 Major Moveable Equipment.--The general characteristics of this equipment are: (a) a relatively fixed location in the building; (b) capable of being moved as distinguished from building equipment; (c) a unit cost sufficient to justify ledger control; (d) sufficient size and identity to make control feasible by means of identification tags; and (e) a minimum life of approximately three years. Major moveable equipment includes such items as accounting machines, beds, wheelchairs, desks, vehicles, x-ray machines, etc.

104.5 Minor Equipment.--The general characteristics of this equipment are: (a) in general, no fixed location and subject to use by various departments of the provider's facility; (b) comparatively small in size and unit cost; (c) subject to inventory control; (d) fairly large quantity in use; and, (e) generally, a useful life of approximately 3 years or less. Minor equipment includes such items as waste baskets, bed pans, syringes, catheters, silverware, mops, buckets, etc.

104.6 Land (Non-Depreciable).--Land (non-depreciable) includes the land owned and used in provider operations. Included in the cost of land are the costs of such items as off-site sewer and water lines, public utility charges necessary to service the land, governmental assessments for street paving and sewers, the cost of permanent roadways and grading of a non-depreciable nature, the cost of curbs and sidewalks whose replacement is not the responsibility of the provider, and other land expenditures of a non-depreciable nature. Although land used in the provision of patient care activities is a capital asset, the cost of which is neither depreciable nor amortizable under any circumstances, the historical cost limitations described in §104.10 apply to the valuation of land for purposes of determining allowable interest expense under §§202.1 and 203 and return on equity capital under §§1202.1 and 1218.12 (if applicable).

104.7 Land Improvements (Depreciable).--Depreciable land improvements include paving, tunnels, underpasses, on-site sewer and water lines, parking lots, shrubbery, fences, walls, etc. (if replacement is the responsibility of the provider).

104.8 Leasehold Improvements.--Leasehold improvements include betterments and additions made by the lessee to the leased property. Such improvements become the property of the lessor after the expiration of the lease.

104.9 Accounting Records.--The depreciation allowance, to be acceptable, must be adequately supported by the provider's accounting records. For Medicare purposes, a provider may maintain supplementary records apart from formal records, but in a manner similar to that used in maintaining formal records. Appropriate recording of depreciation requires the identification of the depreciable assets in use, the assets' historical costs (or fair market value or net book value, as appropriate, at the time of donation in the case of donated assets (see §114.2)), the assets' dates of acquisition, the method of depreciation, estimated useful lives, and the assets' accumulated depreciation.

104.10 Historical Cost. --

A. General--Historical cost is the cost incurred by the present owner in acquiring the asset and preparing it for use. Generally such cost includes costs that are capitalized under generally accepted accounting principles. For example, in addition to the purchase price, historical cost includes architectural fees, consulting fees, and related legal fees.

When an appraisal of a proprietary provider's depreciable assets is necessary because its property records do not adequately reflect the cost of the facility, the cost based on the appraisal may not exceed the capitalized cost basis of the asset used for Federal income tax purposes. However, when a provider has elected for Federal income tax purposes to expense certain items, e.g., taxes and some carrying charges (such as interest), the historical cost basis for Medicare purposes may include the amount of these expensed items unless excluded under subsection C. Subsection C describes the limitations on the historical cost of assets acquired by hospitals or SNFs on or after July 18, 1984 and before December 1, 1997. Subsection E describes the limitations on the historical cost of assets acquired by all providers on or after December 1, 1997.

For the limitation on the inclusion of settlement costs in the historical cost of assets acquired by hospitals or SNFs on or after July 18, 1984, and for all providers on or after December 1, 1997, see subsections C and E. (See §134.3 for further information on asset values of proprietary providers.)

B. For Depreciable Assets Acquired By All Providers After July 1970 and Before December 1, 1997 and By Hospitals or SNFs Before July 18, 1984.--The historical cost must not exceed the lowest of:

- o The acquisition cost of the asset to the new owner,
- o The current reproduction cost adjusted for straight-line depreciation over the life of the asset to the time of the purchase, or
- o The fair market value at the time of the purchase. (See §104.14.)

**C. For Depreciable Assets Acquired By Hospitals or SNFs On or After July 18, 1984 and before December 1, 1997.**--The historical cost shall not exceed the lowest of the following:

- o The allowable acquisition cost for Medicare purposes of the asset to the owner of record as of July 18, 1984 (or in the case of an asset not in existence as of July 18, 1984, the first owner of record of the asset after that date);
- o The acquisition cost of the asset to the new owner; or
- o The fair market value of the asset on the date of acquisition.

**NOTE:** If the acquisition was subject to an enforceable agreement entered into before July 18, 1984, the limitations in subsection B apply.

For the purpose of determining the limitation on historical cost for assets acquired by hospitals and SNFs on or after July 18, 1984:

1. An asset not in existence as of July 18, 1984, includes any asset that physically existed, but was not owned by a hospital or SNF participating in the Medicare program as of July 18, 1984.

2. The acquisition cost to the owner of record is subject to any limitation on historical cost described in subsections A and B above and is not reduced by any depreciation taken by the owner of record.

3. **The acquisition cost to the owner of record includes the costs of betterments or improvements that extend the estimated useful life, increase productivity, or significantly improve the safety of an asset. (See §108.2.)**

4. The acquisition cost to the owner of record for assets acquired prior to a hospital's or SNF's entry into the Medicare program is the historical cost of the asset when acquired, rather than when the hospital or SNF entered the program.

5. The acquisition cost to the owner of record for assets subject to the optional allowance for depreciation described in §124 is the historical cost established for those assets when the hospital or SNF changed to actual depreciation as described in §126. If the hospital or SNF did not change to actual depreciation as described in §126 for optional allowance assets, the acquisition cost to the owner of record is established by reference to the hospital's or SNF's recorded historical cost of the asset when acquired. If the hospital or SNF has no historical cost records for optional allowance assets, the acquisition cost to the owner of record is established by appraisal.

6. The historical cost of an asset acquired on or after July 18, 1984, may not include costs attributable to the negotiation and settlement of the sale or purchase (by acquisition, merger, or consolidation) of any capital asset for which any payment was previously made under the Medicare program. If payment was made for even one cost of this type, all costs of this type must be excluded from the historical cost. (Neither may such costs be included in allowable costs as period costs.) The costs to be excluded include, but are not limited to, appraisal costs (except those incurred at the request of the intermediary under §132.A.1), legal fees, accounting and administrative costs, travel costs, and the costs of feasibility studies. If payment was made for even one cost of this type, all costs of this type must be excluded from the historical cost and are not otherwise allowable.

**EXAMPLE 1:** An SNF was constructed in January 1987 at a cost of \$15 million and approved for Medicare participation. It was sold in 1992 for \$20 million. Its fair market value was \$20 million. The allowable acquisition cost to the new owner is \$15 million.

**EXAMPLE 2:** Hospital XYZ was constructed in 1980. At the time of construction, the provider also incurred costs for architectural fees and for legal fees. These costs were capitalized and reimbursed as depreciation.

In January 1985, the facility was sold. The purchaser incurred costs for a feasibility study, appraisal fees, and accounting fees related to the purchase. Because fees related to the acquisition of the asset were previously reimbursed under the Medicare program, the purchaser may not include any of the fees attributable to the sale (the cost of the feasibility study, the appraisal fees, and the accounting fees) in the historical cost of the asset nor can the purchaser include these costs as period costs.

**EXAMPLE 3:** A hospital was built at a cost of \$10 million and began operation in October 1986. It did not participate in the Medicare program. In May 1993, it was sold for \$12 million, its fair market value, and approved for Medicare participation. Because the hospital had never participated in the program, the allowable acquisition cost to the new owner for Medicare purposes is \$12 million.

**EXAMPLE 4:** The facts are the same as above except the new owner operated the hospital as a nonparticipating hospital until May 1995. At that time, it was approved for Medicare participation. The acquisition cost is \$12 million. The basis for depreciation is the acquisition cost reduced by the depreciation accumulated up to the date of entrance into the program. (See §114.B.)

**EXAMPLE 5:** A nursing facility was constructed in 1983 for \$3 million and has operated since that time as a Medicare approved nursing facility. The facility was purchased in 1992 for \$8 million. The purchase was entirely financed with a mortgage. The fair market value at the time of sale was \$8 million. As a result of §1861(v)(1)(O) of the Act (§2314(a) of DEFRA), the cost basis in the assets was limited to \$3 million. Since the purchase in 1992, the nursing facility has allowed accumulated depreciation of \$600,000.

In 1994, the nursing facility was sold to an unrelated party for a down payment of \$10,000 and the assumption of the facility's outstanding debt of \$8 million. The gain or loss is determined as follows:

Actual sales proceeds	\$8,010,000
Net book value	
determined under §1861(v)(1)(O)*	<u>-\$2,400,000</u>
Gain on sale	\$5,610,000

\* \$3 million less \$600,000

The result of the transaction is a gain of \$5,610,000 on the sale (sales price of \$8,010,000 less the net book value under §1861(v)(1)(O) of \$2,400,000). The maximum amount of the gain recognized by Medicare is limited to the depreciation previously included in Medicare allowable cost, or \$600,000.

Since \$600,000 is less than the total gain of \$5,610,000, the total depreciation taken would be includable in the Medicare cost report as a gain. Had there been a loss on the transaction, the amount of the loss would be limited to \$2,400,000, the undepreciated basis of the asset permitted under the program (\$3,000,000 minus \$600,000).

**NOTE:** The allowable acquisition cost for the new owner (the 1994 purchaser) is \$3 million. For the new owner, interest expense is allowable on only \$2,990,000 of the \$8 million loan assumed. As described in §203, in determining the amount of the loan on which interest expense is allowable, one looks first to the allowable cost of the facility for program purposes (which in this case is \$3 million). From this amount, the owner's investment is subtracted, and the balance is the amount on which interest expense is allowable.

**EXAMPLE 6:** Tom owns a hospital, which he bought for \$1 million in 1980. In 1985, he made improvements of \$250,000 which extended the useful life of the building.

In 1990, Tom sells the hospital to Dick for \$1.1 million. At this point, the historical cost for Dick would be \$1.1 million, the lowest of:

- o 1.25 million which is the original cost to Tom plus the \$250,000 in improvements;
- o \$1.1 million purchase price; or
- o The fair market value which is at least \$1.1 million.

Dick finds that he needs to make improvements before opening for business and spends \$500,000. In 1992, Dick sells the hospital to Harry for \$2 million. The historical cost to Harry would be \$1.25 million, the lowest of:

- o \$1.25 million, the original cost to Tom plus the \$250,000 in improvements made by Tom;
- o \$2 million purchase price; or
- o The fair market value which is at least \$2 million.

D. Hospital-Based Providers Other Than SNFs and SNF-Based Providers.--For changes of ownership before December 1, 1997 that involve assets of a hospital-based provider other than an SNF, or assets of an SNF-based provider, the provisions of subsection C are not applicable. A reasonable allocation of the purchase price must be made so the hospital-based provider other than an SNF, or an SNF-based provider is not affected by the limitations described above. The historical cost of providers other than hospitals and SNFs is governed by subsection B.

E. For Depreciable Assets Acquired By All Providers On or After December 1, 1997. -- The historical cost of the asset to the acquirer will be the historical cost less depreciation allowed to the owner of record as of August 5, 1997 (or if an asset did not exist as of August 5, 1997, the first owner of record after August 5, 1997). The asset moves from the hands of the seller to the hands of the buyer at the assets's net book value defined in §104.23. For purposes of this section, the following apply:

1. An asset that was not in existence as of August 5, 1997 includes an asset that physically existed but was not owned by a provider participating in the Medicare program as of that date.

2. The historical cost to the owner of record is subject to the limitation on historical costs described in section B through D of this section, and is reduced by any depreciation taken by the owner of record. The limitation on historical cost is also applied to the purchase of land, which is a capital asset that is neither depreciable nor amortizable under any circumstances. (See §§200ff for application of the limitation to the cost of land for purposes of determining the allowable interest expense.)

3. Historical cost to the owner of record includes the costs of betterments or improvements that extend the estimated useful life, increase the productivity, or significantly improve the safety of an asset. (See §108.2.)

4. For assets acquired prior to a provider's entrance into the Medicare program, the historical cost to the owner of record is the historical cost when acquired, rather than when the provider entered the program.

5. For assets subject to the optional depreciation allowance as described in §413.139, the historical cost to the owner of record is the historical cost established for those assets when the provider changed to actual depreciation as described in §124. If the provider did not change to actual depreciation, as described in §126, for optional allowance assets, the historical cost to the owner of record is based on the provider's recorded historical cost of the asset when acquired. If the provider has no historical cost records for optional allowance assets, the historical cost to the owner of record is established by appraisal.

6. The historical cost of an asset acquired by hospitals and SNFs on or after July 18, 1984 and by all providers on or after December 1, 1997 may not include costs attributable to the negotiation or settlement of the sale or purchase (by acquisition, merger, or consolidation) of any capital asset for which any payment was previously made under the Medicare program. The costs to be excluded include, but are not limited to, appraisal costs (except those incurred at the request of the intermediary under §132.A.1), legal fees, accounting and administrative costs, travel costs, and the costs of feasibility studies. If payment was made for even one cost of this type, all costs of this type must be excluded from the historical cost and are not otherwise allowable.

**NOTE:** The change in §1861(v)(1)(O) of the Act as amended by §4404 of the Balanced Budget Act (Pub. L. 105-33) has no effect on the recovery of accelerated depreciation as described in §136.

**EXAMPLE 1:** An SNF was constructed in 1990 for \$25 million by Walter and certified for Medicare participation. It was sold in 1995 for \$30 million to Ed. Because of the limitations in C. above, the allowable acquisition cost to Ed is \$25 million. Ed sells the SNF in 1998 for \$30 million to Zelda. Zelda financed the transaction with \$5 M in cash and \$25 M in bonds. The limitation on the selling price is determined as follows:

Historical Cost to Ed	\$25 million
Salvage Value	\$ 1 million
Estimated useful life	32 years
Depreciation	
$\$25 \text{ M} - \$1 \text{ M} = \$24 \text{ M}$	
$\$24 \text{ M} \div 32 =$	\$750,000 per year
Depreciation claimed	\$2, 250,000
Net Book Value on Ed's books	\$22,750,000

There will be no gain or loss on the transaction to Ed. The historical cost to Zelda is \$22,750,000. Zelda's allowable interest expense will be limited to the interest on \$22,750,000, less the \$5,000,000 paid in cash, or \$17,750,000.

**EXAMPLE 2:** In 1995 Mary buys an SNF for \$55 million from Peter who has owned and operated it under the Medicare program since it was built in 1990. The SNF cost \$50 million to build and its net book value on Pete's books is \$45 million. The allowable acquisition costs to Mary is \$50 million. Mary continues to operate it as a Medicare provider and depreciates it at \$1,250,000 a year.

In 1998 Mary converts it to a noncertified nursing home. At that time her net book value is \$46,250,000. She operates it as such until 1999. She sells it to Paul at the end of 1999 for \$55 million. Her net book value at the date of sale is \$45 million. Paul has it certified for Medicare participation in 2000. Paul's basis is \$45 million, less depreciation taken since his date of purchase.

**EXAMPLE 3:** In 1990, Sam builds a hospital at the cost of \$14 million. He operates it as a nonparticipating hospital until 1998. At that time he sells it for \$18 million to Melvin. Melvin makes improvements totaling \$3 million and the hospital is certified for Medicare participation in 1999. In 2001 he sells the hospital to Hal for \$30 million. The net book value on Melvin's books is \$18.4 million. There is no gain or loss on the sale. The historical cost to Hal is \$18.4 million.

**EXAMPLE 4:** Michael buys a SNF in 1983 for \$20 million. He operates it as a Medicare certified facility until 1999, at which time he sells it to Warren for \$6 million. The net book value at the date of sale is \$9 million. There is no gain or loss on the sale. The historical cost to Warren is \$9 million.

104.11 Historical Cost - Trade-Ins.--When an asset is acquired by trading-in an asset that was depreciated under the program, the cost of the new asset is the sum of the undepreciated cost (or fair market value if no cost is assigned) of the asset traded-in and any cash or other assets transferred or

to be transferred to acquire the new asset. However, if the asset disposed of was acquired by the provider before its participation in the Medicare program and the sum of the undepreciated cost and the cash or other assets transferred or to be transferred exceeds the list price or fair market value of the new asset, the historical cost of the new asset is limited to the lower of its list price or fair market value.

For assets having no historical or appraisal values assigned, the cost basis is the fair market value at the date of disposal of the old asset plus the sum paid but not to exceed the lower of the list price or fair market value of the new asset.

104.12 Appraisals.--For Medicare purposes, the term "appraisal" refers primarily to the process of establishing or reconstructing the historical cost, fair market value or current reproduction cost of an asset. It includes a systematic, analytic determination and the recording and analyzing of property facts, rights, investments, and values based on a personal inspection and inventory of the property. (See §§134ff.)

A. Appraisal Date.--The date selected for establishing the value of fixed assets is called the appraisal date. For example, if December 31, 1967, was established as the appraisal date and the actual physical inventory of fixed assets was taken in February 1968, any additions or dispositions of fixed assets between December 1967 and February 1968 must be taken into account in the appraisal values.

B. Appraised Book Value.--The book value of an asset at the appraisal date is its appraised cost as of the date of acquisition less accumulated depreciation computed on any approved basis up to the appraisal date.

C. Appraisal Expert.--An appraisal expert means an individual or a firm that is experience and specialized in multi-purpose appraisal of plant assets involving the establishing or reconstructing of the historical cost, fair market value, or current reproduction cost of such assets; employs a specially trained and well supervised staff with a complete range of appraisal and cost construction techniques; is experienced in appraisals of plant assets used by providers; and demonstrates a knowledge and understanding of the regulations involving reimbursement principles, particularly those pertinent to depreciation.

104.13 Lease-Purchase Assets.--If a lease is a virtual purchase as described in §110.B and the lessee becomes the owner of the leased asset, the historical cost of the asset is the sum of the deferred charge (the difference between the amount of the rent paid and the amount of rent allowed as rental expense) and any additional payments made to acquire the assets, subject to the limitation on revaluation of assets. (See §110.B.2.)

104.14 Purchase of Facility as Ongoing Operation.--

A. The historical cost of assets when an ongoing facility is purchased through a bona fide sale is determined as follows:

1. For depreciable assets acquired after July 1, 1966, and prior to August 1970, the sale price or portion thereof attributable to the asset must not exceed the fair market value of the asset at the time of the sale.

2. For depreciable assets acquired after July 1970 and in the case of hospitals and SNFs, before July 18, 1984, the historical cost must not exceed the lowest of (1) the acquisition cost of the asset to the new owner, (2) the current reproduction cost adjusted for straight-line depreciation over the life of the asset to the time of the purchase, or (3) the fair market value at the time of the purchase. (See §104.15.)

3. For depreciable assets acquired by hospitals or SNFs on or after July 18, 1984, and not subject to an enforceable agreement, the limitations on historical cost specified in §104.10.C are applicable.

4. For depreciable assets acquired by all providers on or after December 1, 1997, the limitations on historical cost specified in §104.10.E are applicable.

B. For changes of ownership on or after December 1, 1997, no gain or loss is recognized on the sale. For changes of ownership before December 1, 1997, the basis for determining the gain or loss to the seller when the facility was being operated under the program at the time of sale is the sales price.

For assets acquired prior to July 1970, the sale price used by the seller in computing gain or loss for the final cost report must agree with the historical cost used by the new provider in computing depreciation.

For an asset acquired after July 1970, the basis for computing gain or loss to the seller is the sales price without regard to any limitation on the basis for depreciation to the buyer as described in §104.10. (See example 5 in §104.10.C.)

The gain or loss on the sale of each depreciable asset must be determined by allocating the lump sum sale price among all the assets sold (including land, goodwill, and any assets not related to patient care), in accordance with the fair market value of each asset as it was used by the provider at the time of sale. If the buyer and seller cannot agree on an allocation of the sale price, or if they do agree but there is insufficient documentation of the current fair market value of each asset, the intermediary for the selling provider must require an appraisal by an independent appraisal expert to establish the fair market value of each asset and must make an allocation of the sale price in accordance with the appraisal. (See §§134ff.) In any case, the sale price must be allocated among all the assets sold, even when, for example, some of the assets will be disposed of shortly after the sale.

C. If a purchaser cannot demonstrate that the sale was bona fide, the seller's net book value must be used by the purchaser as the basis for depreciation of the asset. In such a case, the purchaser must record the historical cost and accumulated depreciation of the seller recognized under the program, and these are considered as incurred by the purchaser for program purposes, such as application of §§132ff. (See §1011.4 if related organizations are involved.)

104.15 Fair Market Value.--Fair market value is the price that the asset would bring by bona fide bargaining between well-informed and unrelated buyers and sellers at the date of acquisition. Usually the fair market is the price at which bona fide sales have been consummated for assets of like type, quality, and quantity in a particular market at the time of acquisition.

104.16 Donated Assets.--An asset is considered donated when the provider acquires the asset without making any payment for it in the form of cash, property, or services. When the provider makes any such payment in acquiring the asset, if the payment is less than the fair market value, then

this payment, and not the fair market value, is considered to be the historical cost of the asset. If an asset is exchanged for new debt or the assumption of debt, then the transaction is considered a sale and not a donation. (For the depreciation basis, see §114.2.)

104.17 Useful Life of Depreciable Assets.--The estimated useful life of an asset is its expected useful life to the provider, not necessarily the inherent useful or physical life. In initially selecting a proper useful life for computing depreciation under the Medicare program, the provider may use certain published useful life guidelines. The guidelines used depend on when the asset was acquired. For assets acquired before January 1, 1981, either the Internal Revenue Service (IRS) or the American Hospital Association (AHA) guidelines may be used. For assets acquired on or after January 1, 1981, only the AHA guidelines may be used.

<u>Date Asset Acquired</u>	<u>Useful Life Guidelines</u>
Before 1/1/81	Internal Revenue Service (IRS) guidelines except those offered by the Asset Depreciation Range System) or the 1973 edition of the <u>AHA Chart of Accounts for Hospitals</u>
On or after 1/1/81, but before 1/1/82	1973 edition of the <u>AHA Chart of Accounts for Hospitals</u>
On or after 1/1/82, but before 1/1/83	1978 edition of the <u>AHA Estimated Useful Lives of Depreciable Hospital Assets</u>
On or after 1/1/83, but before 8/1/88	1983 edition of the <u>AHA Estimated Useful Lives of Depreciable Hospital Assets</u>
On or after 8/1/88, but before 3/1/93	1988 edition of the <u>AHA Estimated Useful Lives of Depreciable Hospital Assets</u> (except Table I)
On or after 3/1/93 but before 3/1/98	1993 edition of the <u>AHA Estimated Useful Lives of Depreciable Hospital Assets</u>
On or after 3/1/98	1998 edition of the <u>AHA Estimated Useful Lives of Depreciable Hospital Assets</u>

The use of the 1978 or later AHA editions allow more detailed component lives for building and building equipment (e.g., automatic doors, canopies, computer flooring, etc.). Each component may be depreciated separately on the basis of the useful life of each component, rather than on the basis of a single useful life for the entire building.

A composite useful life, as illustrated in the 1973 and 1978 editions, may be used for a class or group of assets. In using the 1988 edition, Table 1, which provides useful life ranges for groups of assets, may not be used.

For assets acquired before December 1, 1997, a purchaser of a used asset must assume a useful life based on the guidelines for new assets. However, if approved by the intermediary, the purchaser of a used asset may reduce the useful life based on acceptable factors that affect the establishment of a different useful life as described below. For used assets acquired on or after December 1, 1997, and subject to the historical cost limitation in 104.10E and 104.14A.4 the purchaser must use the remaining useful life .

Purchased computer software acquired prior to August 1, 1988, is depreciated over the useful life of the hardware if the software is purchased with computer equipment and the cost is not separately stated. If the cost of the software is separately stated, or if the software is purchased independent of the hardware, it must be depreciated over a minimum of 5 years. Purchased computer software purchased on or after August 1, 1988, is depreciated using the applicable edition of the useful life guidelines.

The costs of initial customizing and/or modification of purchased computer software to function with the provider's computer hardware, or to put it into place for use, should be capitalized as part of the historical cost of the software. Such costs are analogous to installation costs of a moveable asset.

The costs of internally generated computer software must be expensed, rather than capitalized. For purposes of this section, internally generated computer software means software generated, in whole or in part, by staff internal to the provider. The use of outside consultants to assist the provider's staff in developing a systems change does not change the nature of any resultant software from internally generated to purchased.

The costs of a building addition may be depreciated over the remaining useful life of the primary building to which it is appended, rather than over the inherent physical life of the building addition, if the provider intends to demolish or abandon the primary building and the building addition upon the expiration of the useful life of the primary building. However, the provider must demonstrate to the intermediary by convincing evidence a clear intention to demolish or abandon the building addition at the expiration of the useful life of the primary building (e.g., a master building plan which does not provide for any alternative which would have the building addition remain in place beyond demolition or abandonment of the primary building). If the provider's evidence contains alternatives that would extend the useful life of the building addition beyond the remaining useful life of the primary building, a presumption must be made that the useful life of the building addition corresponds with its inherent physical life, and the shorter useful life may not be used.

A different useful life may be approved by the intermediary if the provider's request is properly supported by acceptable factors which affect the determination of useful life. Such factors include normal wear and tear, obsolescence due to normal economic and technological changes, climatic and other local conditions, and the provider's policy for repairs and replacement. When the useful life selected differs significantly from that established by the guidelines, the deviation must be based on convincing reasons supported by adequate documentation, generally describing the realization of some unexpected event. Factors such as an expected early sale, retirement, demolition, or abandonment of an asset (however, see exception regarding building additions above), or termination from the Medicare program, may not enter into a determination of the expected useful life of an asset.

104.18 Useful Life - Leasehold Improvements.--The costs of improvements which are the responsibility of the provider under the terms of a lease may be depreciated over the useful life of the improvement or the remaining term of the lease, whichever is shorter. The term of the lease includes any period for which the lease may be renewed, extended, or continued following either an option exercised by the provider or, in the absence of an option, reasonable interpretation of past acts of the lessor and lessee pertaining to renewal, etc., unless the provider establishes, omitting past acts, that it will probably not renew, extend, or continue the lease.

104.19 Salvage Value - Depreciable Assets.--Salvage value is the estimated amount expected to be realized upon the sale or other disposition of the depreciable asset when it is no longer useful to the provider. The amount is ordinarily estimated at the time of acquisition and, except for the declining balance method, is deducted from the cost of the depreciable property to arrive at the basis for depreciation. For example, an asset is purchased for \$17,000 with an expected salvage value of \$2,000. The basis for depreciation becomes \$15,000 (i.e., \$17,000 less \$2,000) for computing the depreciation.

Thus, if a provider disposes of its assets when they are in good operating condition, the salvage value is higher than it might be if the provider used the assets until their inherent life had been substantially exhausted. Virtually all assets have a salvage value substantial enough to be included in calculating depreciation, and only in the rare instance is salvage value so negligible that it may be ignored.

For assets acquired on or after December 1, 1997, and subject to the historical cost limitation in 104.10E and 104.14A.4, salvage value need not be taken.

104.20 Scraping.--Scraping is the physical removal from the provider's premises of tangible personal property which is no longer useful for its intended purpose and is only salable for its scrap or junk value.

104.21 Abandonment.--Abandonment means the permanent retirement of an asset for any future purpose, not merely the provider's ceasing to use the asset for patient care purposes. To claim an abandonment under the program, the provider must have relinquished all rights, title, claim, and possession of the asset with the intention of never reclaiming it or resuming its ownership, possession, or enjoyment.

104.22 Demolition.--The deliberate destruction of a building or other asset resulting in the complete loss of economic value (other than the scrap value) of the asset.

104.23 Net Book Value.--The net book value of the asset is defined as the historical cost under the program less the depreciation recognized under the program.

104.24 Bona Fide Sale.--A bona fide sale contemplates an arm's length transaction between a willing and well informed buyer and seller, neither being under coercion, for reasonable consideration. An arm's-length transaction is a transaction negotiated by unrelated parties, each acting in its own self interest.

## 106. METHODS FOR WRITING OFF COST OF MINOR EQUIPMENT

Except where prohibited by §108, a provider may treat the cost of the minor equipment needed to operate its facility in any one of the following methods:

(a) The original investment in this equipment is not amortized or depreciated. Any replacements to the base stock are charged to operating expenses. The investment in the base inventory of equipment is adjusted when there is a significant change in the inventory size. For example:

Provider Fiscal Year - July 1 to June 30

Provider Entered Program - July 1, 1966

Original Cost of Minor Equipment in Use at July 1, 1966 - \$15,000

Purchases During FY July 1, 1966, to June 30, 1967 ----- \$10,000

Minor Equipment Inventory Value at June 30, 1967 ----- \$20,000  
(Determined for this example to be a significant change in inventory size)

Charges to operating expense in FY ended June 30, 1967, are \$5,000. (Purchases of \$10,000 less increase in inventory value of \$5,000)

(b) The net book value of such items at the time the provider enters the program may be written off ratably over 3 years; that is, one third of the net book value is written off each year. Net book value is the historical cost less previous write-off. The previous write-off should have been computed on the basis of not more than a 3-year life and in equal amounts. A full one-third write-off should have been made in the year of acquisition. If the computation had been based on longer life or a different rate, or both, or if the equipment has been previously written off directly through charges to operating expense, the net book value at the time the provider enters the program is amortized applying a 3-year basis. Thus, any asset over 3 years old, although still in use, is not included. Under this method, any new purchases are also written off ratably over a 3-year period. For example:

Provider Fiscal Year - January 1 to December 31

Provider Entered Program - January 1, 1967

<u>Purchase Date</u>	<u>Acquisition Cost of Minor Equipment in Use on 1/1/67</u>		<u>Recomputed Write-Off To 1/1/67</u>		<u>Net Book Value As Of 1/1/67</u>
1965	\$9,000	minus	\$6,000	equals	\$3,000
1966	6,750	minus	2,250	equals	<u>4,500</u>
				Total	<u>\$7,500</u>

Write-Off allowed on above equipment: 1967 - \$2,500  
1968 - \$2,500  
1969 - \$2,500

(c) Equipment still in use may be categorized (e.g., surgical instruments) and written off ratably over their actual useful lives. Where depreciable equipment had been written off directly through charges to operating expense, or previously inaccurately depreciated due to the provider's method of accounting for minor equipment, a new book value of equipment still in use may be recomputed using the actual useful lives.

Once a provider has applied one of the above methods, that method must be consistently used thereafter unless approval for a change is granted by the intermediary. A request for change must be made no later than the last day of the first month of the accounting year in which the new method is to be employed.

Methods (a) and (b) are not methods of depreciation and the rules of this chapter relevant to depreciation are not applicable.

## 108. GUIDELINES FOR CAPITALIZATION OF HISTORICAL COSTS AND IMPROVEMENT COSTS OF DEPRECIABLE ASSETS

**108.1 Acquisitions.**--If a depreciable asset has at the time of its acquisition an estimated useful life of at least 2 years and a historical cost of at least \$5,000, its cost must be capitalized and written off ratably over the estimated useful life of the asset using one of the approved methods of depreciation. If a depreciable asset has a historical cost of less than \$5,000, or if the asset has a useful life of less than 2 years, its cost is allowable in the year it is acquired, subject to the provisions of §106.

The provider may establish a capitalization policy with lower minimum criteria, but under no circumstances may the above minimum limits be exceeded. For example, a provider may elect to capitalize all assets with an estimated useful life of at least 18 months and a historical cost of at least \$4,000. However, it may not elect to capitalize only those assets with a useful life of at least 3 years and a historical cost of more than \$6,000.

When items are purchased as an integrated system, all items must be considered as a single asset when applying the capitalization threshold. Items that have a stand alone functional capability may be considered on an item-by-item basis. For example, an integrated system of office furniture (interlocking panels, desk tops that are supported by locking into panels) must be considered as a single asset when applying the threshold. Stand alone office furniture (e.g., chairs, free standing desks) will be considered on an item-by-item basis.

**108.2 Betterments and Improvements.**--Betterments and improvements extend the life, increase the productivity, or significantly improve the safety (e.g., asbestos removal) of an asset as opposed to repairs and maintenance which either restore the asset to, or maintain it at, its normal or expected service life. Repair and maintenance costs are always allowed in the current accounting period.

For the costs of betterments and improvements, the guidelines established in §108.1 must be followed, i.e., if the cost of a betterment or improvement to an asset is \$5,000 or more and the estimated useful life of the asset is extended beyond its original estimated useful life by at least 2 years, or if the productivity of the asset is increased significantly over its original productivity, or the safety of the asset is increased significantly, then this cost must be capitalized and written off ratably over the remaining estimated useful life of the asset as modified by the betterment or improvement. As in the previous section, lower minimum criteria may be used if desired.

## 110. SALE AND LEASEBACK AND LEASE-PURCHASE AGREEMENTS

### A. Sale and Leaseback Agreements - Rental Charges.--

1. The incurred rental specified in the sales agreement entered into by hospitals or SNFs before Oct. 23, 1992, or by other providers at any time, is includable in allowable costs if the agreement is with a nonrelated purchaser involving plant facilities or equipment and the following conditions are met:

o The rental charges are reasonable based on consideration of rental charges of comparable facilities and market conditions in the area; the type, expected life, condition and value of the facilities or equipment rented; and other provisions of the rental agreements;

o Adequate alternate facilities or equipment which would serve the purpose are not or were not available at lower cost; and

o The leasing was based on economic and technical considerations.

2. When a hospital or SNF enters into a sale and leaseback agreement on or after October 23, 1992, or in the case of other providers, when the conditions in subsection A are not met, and the agreement is with a nonrelated purchaser involving plant facilities or equipment, the amount that may be included as rental or lease expense may not exceed the amount that the provider would have included in its allowable costs had the provider retained legal title to the facility or equipment (i.e., the costs of ownership). The costs of ownership include items such as interest expense on mortgages, taxes, depreciation, and insurance costs.

The limitation on the amount that may be included in lease or rental costs applies both on an annual basis and over the useful life of the asset.

a. If in the early years of the lease, the annual lease costs are less than the annual costs of ownership, but in the later years of lease, the annual lease costs are more than the costs of ownership, the limitation is applied as follows.

In the years when the lease costs are less than the costs of ownership, the actual annual lease costs are included in allowable costs. However, in the later years of the lease, when the annual lease costs are greater than the annual ownership costs, the full lease costs may be included so long as, in the aggregate, the total costs of the lease do not exceed the total costs of ownership over the life of the asset.

EXAMPLE: A 10 year lease has lease costs of \$10,000 per year. The asset has a useful life of 12 years. The costs of ownership is \$11,000 per year for the first 3 years, \$9,000 for the next 2 years, and \$6,000 a year thereafter, with a total costs of ownership of \$93,000.

	<u>Lease</u>	<u>Ownership</u>	<u>Allowable (per year)</u>	<u>Total Cumulative</u>
Years 1-3	\$10,000	\$11,000	\$10,000	\$30,000
Years 4-5	\$10,000	\$ 9,000	\$10,000	\$20,000
Years 6-9	\$10,000	\$ 6,000	\$10,000	\$40,000
Year 10	\$10,000	\$ 6,000	\$ 3,000	\$ 3,000
Years 11-12	\$ 0	\$ 6,000		\$ 0
Total	\$100,000	\$93,000		\$93,000

b. If in the early years of the lease, the annual lease costs are greater than the annual ownership costs, but in the later years of the lease the annual lease costs are less than the annual ownership costs, the limitation is applied as follows.

In the years that the annual lease costs exceed the costs of ownership, the provider may carry forward lease costs that are excluded from allowable costs because of the annual limit. The amounts carried forward are included in allowable costs in the years of the lease when the lease costs are less than the annual costs of ownership. However, in any year, the amount of actual annual lease costs plus the amount carried forward may not exceed the annual cost of ownership for that year. In addition, in the aggregate, the amount of rental or lease costs included in allowable costs may not exceed the costs of ownership that the provider could have included in allowable costs had the provider retained legal title to the asset.

EXAMPLE: There is a 10 year lease with lease costs of \$9,000 per year. The costs of ownership is \$7,000 per year for the first 3 years, \$9,000 for the next 2 years, and \$10,000 a year thereafter, with a total costs of ownership of \$89,000.

	Costs			
	Lease	Ownership	Allowable	Total
	_____	(per year)	(per year)	Cumulative
Years 1-3	\$9,000	\$7,000	\$ 7,000*	\$21,000
Years 4-5	\$9,000	\$9,000	\$ 9,000	\$18,000
Years 6-10	\$9,000	\$10,000	\$10,000**	\$50,000
Total		\$90,000	\$89,000	\$89,000

\* \$1,000 per year is carried forward

\*\* includes \$1,000 per year carries forward from years 1-3

NOTE: \$1,000 in carry forward costs are not recognized because the total cost of ownership would be exceeded.

#### B. Lease Purchase Agreements - Rental Charges.--

##### 1. Definition of Virtual Purchase.--

a. For lease transactions of all providers entered into before October 23, 1992, the existence of the following conditions generally establishes that a lease is a virtual purchase.

o The rental charge exceeds rental charges of comparable facilities or equipment in the area;

o The term of the lease is less than the useful life of the facilities or equipment; and

o The provider has the option to renew the lease at a significantly reduced rental, or the provider has the right to purchase the facilities or equipment at a price which appears to be significantly less than what the fair market value of the facilities or equipment would be at the time acquisition by the provider is permitted.

b. For lease transactions of all providers entered into on or after October 23, 1992, a lease that meets any one of the following conditions establishes a virtual purchase.

o The lease transfers title of the facilities or equipment to the lessee during the lease term,

o The lease contains a bargain purchase option,

o The lease term is 75 percent or more of the useful life of the facilities or equipment. This provision is not applicable if the lease begins in the last 25 percent of the useful life of the facilities or equipment, or

o The present value of the minimum lease payments (that is, payments to be made during the lease term, including bargain purchase option, guaranteed residual value, or penalties for failure to renew) equal 90 percent or more of the fair market value of the leased property. This provision is not applicable if the lease begins in the last 25 percent of the useful life of the facilities or equipment. The present value is computed using the lessee's incremental borrowing rate, unless the interest rate implicit in the lease is known and is less than the lessee's incremental borrowing rate, in which case, the interest rate implicit in the lease is used.

2. Treatment of Rental Charges.--If the lease is a virtual purchase, the rental charge is includable in allowable costs only to the extent that it does not exceed the amount which the provider would have included in allowable costs if it had legal title to the asset (the cost of ownership), such as straight line depreciation, insurance, and interest. For purposes of computing the limitation on allowable rental cost, a provider may not include accelerated depreciation in its allowable costs.

The difference between the amount of the rent paid and the amount of rent allowed as rental expense is considered a deferred charge and is treated as follows:

a. If the asset is purchased by the provider, the deferred charge must be capitalized as part of the historical cost of the asset, subject to the limitation on revaluation of assets, and is depreciated over the useful life of the asset.

b. If the asset is returned to the owner, instead of being purchased, the deferred charge may be expensed in the year the asset is returned.

c. If the term of the lease is extended for an additional period of time at a reduced lease cost and the option to purchase still exists, the deferred charge may be expensed to the extent of increasing the reduced rental to an amount not in excess of the cost of ownership.

d. If the term of the lease is extended for an additional period of time at a reduced lease cost and the option to purchase no longer exists, the deferred charge may be expensed to the extent of increasing the reduced rental to a fair rental value.

If the lessee becomes the owner of the leased asset (either by operation of the lease or by other means), the amount considered as depreciation for the purpose of having computed the limitation expressed in the first paragraph

of the section must be used in calculating the limitation on adjustments to depreciation for the purpose of determining any gain or loss upon disposal of an asset under §132.

e. If the provider undergoes a change of ownership (CHOW) during the lease period, and the lease is assigned to the new owner (with no changes to the lease terms), the deferred rental charge is treated as follows:

1. If the CHOW is between or among unrelated entities, any rental amount deferred as of the date of the CHOW is included in the terminating provider's final cost report. The acquiring provider must apply the above limitations in determining the amount of rental charges to be included in its allowable costs. **EXCEPTION:** If the terms of the lease changed in addition to the assignment of the lease, the new lease must be evaluated to determine if it should still be considered as lease-purchase agreement.
2. If the CHOW is between or among related organizations, the lease is treated as if a CHOW had not occurred (i.e., the deferred rental amount may not be included in the termination provider's final cost report, and the above limitations will continue to apply in determining the amount of rental expense that may be included in the allowable costs of the acquiring provider.

**EXAMPLE:** A provider leased the following asset for 5 years at a cost of \$75,000 per year. The asset costs \$300,000 and has a useful life of 6 years. The cost of ownership was determined as follows:

Cost	\$300,000
Useful Life	6 years
Depreciation	\$50,000 per year
Insurance	\$ 3,000 per year
Interest	\$12,000 per year

The yearly cost of ownership is \$65,000. It was determined that this was a virtual purchase. The rental charge included in allowable expense is limited to \$65,000 and the difference of \$10,000 is deferred.

The asset is then purchased by the provider at the end of the lease for \$30,000. The basis of the asset is \$30,000 plus 5 years deferred charges at \$10,000 or a total of \$80,000. The useful life is 6 years and the salvage value is \$2,000. The purchaser of a used asset must assume a useful life based on the guidelines for new assets unless a different useful life is justified to the intermediary. (See §104.17.)

The provider keeps the asset for 4 years and sells it for \$35,000. The gain or loss on the sale is determined as follows:

Basis	\$80,000
Depreciation	\$52,000
Undepreciated Basis	\$28,000
Sales Price	\$35,000
Gain	\$ 7,000

The maximum amount of the gain recognized by Medicare is limited to depreciation previously included in Medicare allowable cost or \$52,000. Had

there been a loss on the transaction, the amount of the loss would be limited to \$28,000, the undepreciated basis of the asset permitted under the program.

3. Effect of Funded Depreciation.--When a provider which has funded depreciation available leases an asset and it is determined that the lease is a virtual purchase, the lease charge is recognized as described in subsection 2. However, in determining the cost of ownership for comparison to the cost of leasing, the provider must not include a factor representing imputed interest expense. Since the provider had funded depreciation available, it would not have incurred interest expense related to the purchase. While the implicit interest expense cannot be included in determining the limitation, it is not unallowable. Rather, the implicit interest is deferred as part of the excess of the lease payment over the costs of ownership when funded depreciation is available. The excess of any reasonable rental or lease charge over the costs of ownership is not disallowed. As described in subsection 2, this excess is deferred and either (1) reimbursed when the asset is returned to the lessor or (2) included in the historical cost basis of the asset when the asset is purchased by the lessee.

#### 111. ASSUMPTION OF LEASE AT LESS THAN FAIR RENTAL VALUE

There are some situations in which a provider may obtain lease rights for less than fair rental value when, for example, a provider assumes an existing lease on a tangible asset(s) as part of the purchase of a group of assets, which includes the favorable lease. In such situations, the provider is actually paying to obtain the favorable lease. If the provider and the entity from which the lease is assumed are not related within the meaning of Chapter 10, and if the essential elements of the lease (e.g., lease payments, lease term, responsibilities of lessor and lessee) remain unchanged as a result of the lease assumption, the reasonable amount paid for purposes of obtaining the lease (in excess of the actual amount of rent which must be paid under the lease) may be ratably amortized over the life of the lease (excluding renewal periods) so long as the leased assets are used to render patient care. If the lease is terminated before the amortization period is completed, the unamortized amount may be included in allowable cost in the year of termination. The reasonable amount for purposes of obtaining the favorable lease must be documented as having been paid for the lease, and it must be shown that the amount of rent required under the lease plus the amount paid for purposes of obtaining the favorable lease does not exceed the fair rental value of the lease.

**EXAMPLE:** In 1985, Corporation A purchases the assets of Hospital B, a provider corporation not related to Corporation A within the meaning of Chapter 10. Corporation A continues operation of the hospital as a participating provider. The assets purchased include a hospital building, building equipment, major moveable equipment, land, and a lease on a storage building located on property adjacent to the hospital property. The storage building is used to store provider assets related to patient care. The storage building and the land upon which it is situated is owned by Partnership XYZ (lessor), an organization not related to either Corporation A or Corporation B within the meaning of Chapter 10.

In 1980, when the lease was originally negotiated between Partnership XYZ and Provider B, the lease provided for a reasonable first year rental amount to be increased no more than 5 percent per year. The term of the lease was 10 years and the lease was assignable. From 1980 through the date of the sale of the hospital to Corporation A, fair rental values for similar rental properties have increased at the rate of 8 percent per year.

Corporation A, in recognition of the fact that it is assuming a favorable lease (at less than fair rental value), paid an additional, reasonable amount to Hospital B for the favorable lease. The amount paid in recognition of the favorable lease is

documented in the sales agreement. The additional amount paid for the favorable lease may be ratably amortized over the remaining life of the lease (5 years), so long as the building continues to be used for a purpose related to patient care.

#### 112. ALLOWANCE FOR DEPRECIATION ON FACILITIES LEASED FOR NOMINAL AMOUNT

A considerable number of providers lease their facilities from municipalities at a nominal rental (usually for \$1.00 per year) with the lease generally covering the useful life of the facility. Under most lease arrangements, the tenant (lessee) maintains the property and pays the cost of any improvement or addition to the facility. When such improvement or addition is made, the lessee may properly depreciate its cost. The depreciation allowance is includable in allowable cost. At the end of the lease, improvements and additions made by the lessee become the property of the lessor. However, in some instances, the lease agreement provides that title to any additions or improvements is to revert to the owner in the first year they are used. In such cases, the cost of any addition or improvement is similarly depreciated, and the depreciation allowance is also includable in allowable cost.

It is the general practice of the provider to include in its charges (and cost) an amount to cover depreciation on the leased facilities as distinguished from capital improvements made by the lessee. In recognition of this practice, most third parties that reimburse providers on the basis of cost allow depreciation (but not interest) on facilities that have been leased for a nominal rental. In view of this and since the lease arrangement in such cases generally contemplates the occupancy by the lessee for the period of the useful life of the facility, depreciation on the leased facility may be included in allowable cost under the conditions described below.

112.1 Analysis of Lease Arrangement.--Each case must be decided on its own merits for depreciation to be allowed. The lease must contemplate that the lessee will make any necessary improvements and properly maintain the facility. The lease may and frequently does cover the useful life of the asset. If not, however, as in the case of a year to year lease, such lease is examined closely to determine whether the renewal and other provisions of the lease contemplate that the provider will use the facility to the extent of its useful life. Where the intent and provisions of the year to year lease permit the provider to have the benefit of the useful life of the facility, such lease is treated, for depreciation purposes, in the same manner as a long-term lease that covers the useful life of the asset. The actions of the lessee and lessor in such cases should indicate that the intent of both parties is to continue the lease arrangements for the useful life of the asset. Of course, other facts are considered together with the past actions of the lessee and lessor in order to determine whether or not the asset will and can be used by the lessee for the asset's full useful life.

The lease should have no restrictions on the free use of the facility by the lessee. In addition, the lease should not provide for any indirect benefits to the lessor or to those connected with the lessor. For example, if the lease requires that the lessee furnish free hospital services to the employees of the lessor, then depreciation is not allowed. In such case, the cost of the services furnished to the lessor's employees is appropriately included when determining Medicare's share of allowable costs.

When the provider pays or contributes to the lessor any funds which are to be used for retiring the lessor's bonds or notes issued for the facility, such payments are considered rental payments. These rental payments, to the extent they are reasonable, are considered an allowable cost. Also, any general contribution by the lessee to the lessor is considered a rental payment for the use of the facility. When either of such rental payments is allowable as cost, depreciation on the leased facility is not an allowable cost item.

Any questions on the legal interpretation of the lease as it relates to the criteria discussed above, should be submitted through the Bureau of Health Insurance regional office for an opinion from the regional attorney.

112.2 Basis and Method for Depreciation.--For depreciation cost allowance purposes under the program, the leased asset should be treated as though the lessor and lessee were one and the same. All the cost principles and reimbursement manual sections on depreciation would be applicable to such assets. For example, the basis for depreciation will be the historical cost of the asset to the lessor adjusted for past depreciation. If historical cost records are not available, a proper appraisal for establishing the historical cost would be acceptable. Where the leased facility is later purchased by the provider, the facility's undepreciated balance on the date of title transfer or the purchase price, whichever ever is lower, will, for further depreciation purposes, be considered the unrecovered cost of the facility.

The following illustration demonstrates the computation of depreciation on the leased facility and amortization on improvements made to that facility.

### FACTS

Historical cost of the leased facility at acquisition date--7/1/56 .....	\$520,000
Estimated salvage value .....	\$ 20,000
Estimated useful life of the facility .....	40 years
Life of the lease effective at 7/1/60 .....	35 years
Method of depreciation .....	Straight Line
Leasehold improvement 7/1/65.....	\$ 90,000
Estimated useful life of improvement.....	30 years

### COMPUTATION OF DEPRECIATION

Historical cost of building.....	\$520,000
Less: Estimated salvage value ....	<u>20,000</u>
Basis for depreciation .....	\$500,000
Annual rate of depreciation based on 40 year life .....	2.5%
Annual depreciation on building.....	<u>\$ 12,500</u>
Accumulated depreciation on 7/1/66 (Date of entrance into Medicare program)(10 years at \$12,500 .....	<u>\$125,000</u>

### COMPUTATION OF AMORTIZATION ON IMPROVEMENT

Cost of leasehold improvement .....	\$ 90,000
Useful life--30 years	
Annual amortization .....	<u>\$ 90,000 ÷ 30 years.....\$ 3,000</u>
Accumulated amortization on 7/1/66 (Date of entrance into Medicare program).....	<u>\$ 3,000</u>

TOTAL ANNUAL DEPRECIATION AND AMORTIZATION

Annual depreciation on facility.....	\$12,500
Annual amortization on improvement .....	3,000
Total .....	<u>\$15,500</u>

## 113. LEASING ARRANGEMENTS THAT REQUIRE THE LESSOR TO FURNISH NORMAL BASIC SERVICES

113.1 Lessor - Lessee Arrangements.--Owners of some facilities enter into agreements providing for leasing a stated number of beds in their institutions. Under these arrangements, the lessor-operator of the facility agrees to provide the equipment, furnishings, supplies, meals, maintenance and janitorial services necessary for the lessee's operation of a portion of the premises, usually as skilled nursing facility under the Medicare program. Usually, the lessor also provides all necessary nursing services or at least provides an option for the lessee to use the lessor's nursing services. The arrangements vary widely in their provisions. However, from the standpoint of patient care, there is apparently little difference in the manner that medical care would actually be provided whether or not a leasing arrangement existed.

The lease usually provides for a rental payment that is not representative of the actual costs of the services furnished. Ordinarily, the rental payment closely approximates or exceeds the facility's normal charges. The rental amount may be stated in a variety of ways; the lessor's normal charges; a modification of the standard charges representing a stipulated reduction; a monthly rental per bed plus a supplemental payment for general overhead and the purchase at the predetermined rates of specific services such as meals, laundry, medical supplies, and all the usual ancillary services such as drugs, physical therapy, etc.; and many other variations.

Regardless of the parties' motivations for entering into such an agreement, the result of the transaction is to guarantee the lessor a return on a charge basis for providing facilities and services, whether or not utilized by program beneficiaries, as provided in section 1814(b) of the Act. The total situation must be considered in a determination of reasonableness of the cost base especially where the lessor itself engaged in the operation of a health facility within the same structure leased in part to the provider.

Where leasing arrangements described above exist, the intermediary should notify the appropriate Bureau of Health Insurance Regional Representative (where SNF's are concerned, the Office of Long-Term Care Standards enforcement in the Regional Director's Office) so that he may determine whether the certification of the lessee distinct-part is proper. The provisions of each such lease will be reviewed to determine whether the "lessee-provider" is actually a certifiable skilled nursing facility. Whether or not the institution meets the definitions of a "skilled nursing

facility" in §1861(j) of the Act, the full circumstances under which it proposes to provide services to beneficiaries on a reasonable cost basis must be reviewed and weighted by the regional office to assure compliance with the Act. Preferably, this is done before an agreement is entered into. However, the certification ordinarily can only be made based upon the on-going operation in order to assure compliance.

113.2 Reimbursement.--When an entire facility or a skilled nursing care distinct-part has been leased by a provider under an arrangement whereby the lessor operates and furnishes essential services, and the lessee requires payments to the lessor that are not representative of the actual cost of the facilities or services furnished by the lessor, the program does not recognize such payments for reimbursement purposes. The program reimburses the lessee only on the basis of the lessor's reasonable costs of furnishing the services. Generally speaking, this involves two cost finding processes - one for the lessor, which requires a determination of cost attributable to the leased distinct-part of the entire facility, if applicable; and one for the lessee's actual operation. The lessor's costs are determined under the Medicare reimbursement principles except that there are no provisions for (1) owner's compensation, or (2) return on equity capital. However, these times are appropriately recognized in the cost finding procedure for the lessee. In addition, any costs for duplicate identifiable services between the lessor and lessee must be eliminated from the lessor's cost.

#### 114. BASIS FOR DEPRECIATION

A. New Assets.--The basis for depreciation of new assets under the straight-line (see §116.1) and the sum-of-the-years' digits (see §116.2) methods is the historical cost of the asset less its salvage value. For the historical cost of donated assets, see §104.16. Section 116B explains the conditions under which the sum-of-the-years' digits method may be used.

Under the declining balance method (see §116.3), the basis for depreciation is the historical cost only. Sections 116B and C explain the applicability and limitation of the use of the declining balance method.

B. Assets Partially or Fully Depreciated on Provider's Books When Provider Enters Program.--For assets that are fully or partially depreciated on the provider's books when the provider enters the program, the basis for depreciation under the straight-line (see §116.1) and the sum-of-the-years' digits (see §116.2) methods is the adjusted historical cost, as defined below, less the salvage value. Section 116B explains the conditions under which the sum-of-the-years' digits method may be used.

Under the declining balance method (see §116.3), the basis for depreciation is the adjusted historical cost only. Sections 116B and C explain the applicability and limitation of use of the declining balance method.

The adjusted historical cost of an asset that is in use when the provider enters the program is its historical cost reduced by the depreciation accumulated up to the date of entrance into the program. Accumulated depreciation for this purpose may be determined on a straight-line basis (regardless of the depreciation method used or in use by the provider) and based on an estimate of the asset's useful life, taking into account past and current information.

When a provider enters the program, it has an opportunity to revise the useful life of its assets taking into account past and current information, subject

to the approval of the intermediary. For example, if an asset currently in use has been fully depreciated on the provider's books, it would be evident that the asset's useful life has not ended. Consequently, a new estimate of the asset's useful life, based on current information, may be made.

When the useful life of an asset is revised, the adjusted historical cost is based on the historical cost reduced by the revised accumulated depreciation based on the new estimate of the asset's useful life.

The revised depreciation may be determined on a straight-line basis regardless of the depreciation method used or in use by the provider. The amount of depreciation on the provider's books is not be considered in the determination.

The following illustrates how the basis for depreciation is determined for used assets when a provider enters the program and revises the useful life of an asset.

### FACTS

The provider entered the program on July 1, 1993

Asset acquired on July 1, 1987.

Original estimated useful life is 8 years.

Historical cost of the asset	\$1,500,000
Estimated salvage value	\$100,000
Accumulated depreciation on the provider's books, using the straight line method of depreciation	\$1,050,000

When the provider entered the program, it reevaluated the useful life of the asset and estimated that its useful life was 12 years from the date of acquisition. The intermediary approved the change. The basis for depreciation under the program is determined as follows:

#### Step 1. Determine adjusted historical cost:

Historical cost	\$1,500,000
Less estimated salvage value	<u>100,000</u>
Basis for computing revised accumulated depreciation	<u>\$1,400,000</u>
Revised accumulated depreciation (6/12 x \$1,400,000)	<u>\$700,000</u>
Adjusted historical cost:	
Historical cost	\$1,500,000
Less revised accumulated depreciation	<u>700,000</u>
Adjusted historical cost	<u>\$800,000</u>

#### Step 2. Determine basis for depreciation under the program:

Using the straight-line method:	
Adjusted historical cost	\$800,000
Less estimated salvage value	<u>100,000</u>
Basis for depreciation	<u>\$700,000</u>

NOTE: The method of determining the accumulated depreciation and the adjusted historical cost for depreciation under the program is the same, regardless of the method of depreciation previously used by the provider.

### 114.1 Transfer of Governmental Facilities.--

A. Intergovernmental Transfer of Facilities.--When assets are transferred from one governmental entity to another under appropriate legal authority, the basis for depreciation is determined as follows.

1. Bona Fide Sale.--The basis for depreciation in a bona fide sale is the historical cost subject to the following limitations.

a. For assets acquired by other than hospitals or SNFs after 1970 and before December 1, 1997, or for assets acquired by hospitals or SNFs after 1970 and before July 18, 1984, the historical cost incurred by the present owner in acquiring the asset under a bona fide sale must not exceed the lower of:

(1) The current reproduction cost adjusted for straight-line depreciation over the life of the asset to the time of the purchase; or

(2) Fair market value at the time of the purchase.

b. For assets acquired by hospitals or SNFs on or after July 18, 1984 (see §104.10.C) and before December 1, 1997, the historical cost cannot exceed the lower of:

(1) The allowable acquisition cost, for Medicare purposes, of the asset to the owner of record as of July 18, 1984 (or in the case of an asset not in existence as of July 18, 1984, the first owner of record of the asset after that date);

(2) The acquisition cost of the asset to the new owner; or

(3) The fair market value of the asset on the date of acquisition.

c. For assets acquired by all providers on or after December 1, 1997, the allowable acquisition cost to the acquirer will be the historical cost less depreciation allowed to the owner of record as of August 5, 1997. (See §104.10.E.)

2. Donation.--An asset is considered donated when a governmental entity acquires the asset without assuming the functions for which the transferor used the asset or without making any payment for it in the form of cash, property, or services. To determine the basis for depreciation of a donated asset, see §114.2.

3. If neither items 1 or 2 above applies, i.e., the transfer was solely to facilitate administration or to reallocate jurisdictional responsibility, or the transfer constituted a taking over in whole or in part of the function of one governmental entity by another governmental entity, the basis for depreciation is:

a. For an asset on which the transferor has claimed depreciation under the Medicare program, the transferor's basis under the Medicare program prior to the transfer. The method of depreciation used by the transferee may be the same as that used by the transferor, or the transferee may change the method. (Beginning August 1, 1970, a provider may only change from an accelerated method or optional method to the straight-line method. See §120.)

b. For an asset on which the transferor has not claimed depreciation under the Medicare program, the cost incurred by the transferor in acquiring the asset (not to exceed the basis that would have been recognized had the transferor participated in Medicare program) less depreciation calculated on the straight-line basis over the life of the asset to the time of transfer.

B. Transfer of State Hospital to Nonprofit Corporation Without Monetary Consideration.--If a State transfers a hospital to a nonprofit corporation without monetary consideration on or after July 18, 1984, the depreciable basis of the assets to the new owner is the net book value of the assets as recorded on the State's books at the time of the transfer. For the purpose of this section, monetary consideration includes cash, new debt, and assumed debt.

114.2 Assets Donated to Provider.--Where an asset is donated to a provider as described in §104.16, the basis for depreciation is determined as follows.

1. Assets Not Used or Depreciated Under Medicare Program.--If an asset has never been used or depreciated under the Medicare program and is donated to a provider, the basis for the purpose of calculating depreciation and equity capital (if applicable) is the fair market value of the asset (see §104.15) at the time of donation.

2. Assets Used or Depreciated Under Medicare Program.--If an asset has been used or depreciated under the Medicare program and is donated to a provider or when a provider acquires such assets through estate or intestate distribution, e.g., a widow inherits a skilled nursing facility upon the death of her husband and becomes the owner of a newly certified provider, the basis for the purpose of calculating depreciation and equity capital (if applicable) is:

- a. The fair market value at the time of donation; or
- b. The net book value in the hands of the owner last participating in the Medicare program.

For donated assets, the basis for depreciation is determined as of the date of donation or the date of death, whichever is applicable. See §104.23 for determining net book value and §104.16 for determining fair market value of donated assets.

When the provider's records do not contain the fair market value of the donated assets as of the date of donation, an appraisal of such fair market value by a recognized appraisal expert is acceptable for depreciation and owner's equity capital purposes.

The provider furnishes its intermediary with information identifying the appraisal expert and type and method of appraisal to be used. The intermediary determines whether the contemplated appraisal is acceptable. (See §§134ff.)

## 116. DEPRECIATION METHODS

A. **General.**--The straight-line method of computing depreciation is acceptable for all depreciable assets. **The availability of various methods of accelerated depreciation is dependent upon the date the asset was acquired and other criteria described in paragraphs B and C.** Regardless of the method of depreciation being used, an asset should not be depreciated below its salvage value (see § 104.18). The depreciation method used in claiming depreciation on a particular asset for the first time will be presumed to be the depreciation method selected for the asset. A provider need not use the same method for all depreciable property.

B. **Depreciation Method Applicable to Acquisition or transaction Before August 1970.**--For the following depreciable assets, in addition to the straight-line method of depreciation, a declining balance method (not to exceed double the straight-line rate or the sum of the years' digits method may be used:

1. Depreciable assets for which accelerated depreciation was used for health insurance program purposes prior to August 1970.

2. Depreciable assets for which a timely request to change from straight-line depreciation to accelerated depreciation was received by the intermediary prior to August 1970.

3. Depreciable assets acquired before August 1970, where no election to use straight-line depreciation, accelerated depreciation, or the optional allowance for depreciation was in effect on such date and the provider was participating in the program on such date. An asset is considered acquired as of the date it is within the control of the provider.

4. Depreciable assets of a provider where construction, remodeling, reconstruction, or other capital improvements began prior to February 5, 1970, and the provider was participating in the program on February 5, 1970. Construction is deemed to begin when physical work is started on the project at the site of the facility. Preliminary work such as planning agency approval, demolition of old buildings, land clearing, feasibility surveys, and architectural drawings are not considered the beginning of construction.

5. Depreciable assets of a provider where a valid written contract was entered into by the provider participating in the program before February 5, 1970, for construction, acquisition, or for the permanent financing thereof and such contract was binding on the provider on February 5, 1970, and at all times thereafter. The contract must identify the asset and specify the cost of the asset. The contract may permit minor modifications in the construction of the asset and in the cost of the asset.

The contract for permanent financing must be for the construction or acquisition of a specific facility or asset. An open-ended commitment by a bank or other institution to furnish funds for the construction or acquisition of a facility or asset is not considered a binding contract for permanent financing.

Approval for financing with Hill-Burton or Hill-Harris program funds or loans insured by the FHA are considered contracts for permanent financing. These loans must have been approved prior to February 5, 1970, and must be designated for the construction or acquisition of a specific facility or asset.

The issuance of bonds to finance the construction or acquisition of a facility or asset is considered a valid contract for permanent financing. The bond issuance must be designated for the construction or acquisition of a specific asset or facility. Final approval of the bond issuance must have occurred prior to February 5, 1970.

C. Depreciable Assets Acquired After July 1970.--For depreciable assets acquired after July 1970 (except for assets acquired as described in B.4 or B.5 above), a declining balance method not to exceed 150 percent of the straight-line rate may be used where the cash flow from depreciation on the total assets of the institution which are used to provide patient care services during the reporting period, including straight-line depreciation on the assets in question, is insufficient (assuming funding of available capital not required currently for amortization and assuming reasonable interest income on such funds) to supply the funds required to meet the reasonable principal amortization schedules on the capital debits related to the provider's total depreciable assets used to provide patient care services. For each depreciable asset for which a provider submits a written request to use a declining balance method for health insurance reimbursement purposes (not to exceed 150 percent of the straight-line rate), the provider must demonstrate to the intermediary's satisfaction that the required cash flow need exists. For each depreciable asset where a provider justifies the use of accelerated depreciation, the intermediary must give written approval for the use of a depreciation method other than straight line before basing any interim payment on the accelerated depreciation or making a reasonable cost determination for a reporting period which included an allowance for such depreciation.

116.1 Straight-Line Method.--Under this method the annual allowance is determined by dividing the cost of the asset (less any estimated salvage value) by the years of useful life. This method produces a uniform allowance each year. The following examples illustrate how depreciation is computed:

## NEW ASSET

Facts: Acquisition	\$17,000
Estimated salvage value	2,000
Estimated useful life	5 years
Annual depreciation is computed as follows:	
Acquisition cost	\$17,000
Less: Estimated salvage value	2,000
Basis for depreciation	<u>\$15,000</u>
<u>Basis for Depreciation</u> Depreciation per annum	
Useful Life	
<u>\$15,000</u> = \$3,000 each year	
5 years	

The annual allowance can also be computed by using a percentage applied to the basis for depreciation. For example, in the above illustration, a 5-year life produces a 20% rate (100%/5 years). This 20% rate, when applied to the \$15,000 basis for depreciation, results in an annual \$3,000 depreciation allowance for each of the 5 years.

## USED ASSET

Facts: Historical cost	\$46,000
Salvage value	1,000
Estimated useful life	15 years
Years asset used by provider before entrance into program	10 years
Straight-line method of depreciation to be used for Medicare purposes.	
Annual depreciation is computed as follows:	
a. Determine the number of remaining years of useful life (15 years minus 10 years = 5 years of remaining useful life).	
b. Determine the basis for depreciation as follows:	
Cost	\$46,000
Deduct: Salvage value	<u>1,000</u>
Balance	\$45,000
Deduct: Accumulated depreciation under the straight-line method for 10 years	
<u>(10 years x \$45,000) =</u>	<u>\$30,000</u>
15 years	
Basis for depreciation	<u>\$15,000</u>
c. Divide the basis for depreciation by the number of years of remaining life:	
<u>Item b = \$15,000</u> = \$3,000 annual depreciation	
Item a 5 years	

116.2 Sum-of-the-years' Digit Method.--Under this method, the annual depreciation allowance is computed by multiplying the basis for depreciation (cost less estimated salvage value) by a constantly decreasing fraction. The numerator of the fraction represents the remaining years of useful life of the asset at the beginning of each year, and the denominator represents the sum of the years of estimated useful life at the time of acquisition in case of new assets or at time of entrance into the program in the case of used assets. The following example illustrates how depreciation is computed:

**NEW ASSET**

Facts: Cost .....\$17,000  
 Estimated salvage value..... 2,000  
 Estimated useful life .....5 years

Depreciation is computed as follows:

- Add each number in the estimated useful life (5 years:  $1+2+3+4+5=15$ ).
  - Use the sum 15 as the denominator of the fraction.
  - Each year, for the numerator of the fraction use the remaining years of useful life including the year for which depreciation is taken. This means using each number in a. above in inverse order (5,4,3,2,1), i.e., 5 for the first year, 4 for the second year, 3 for the third year, etc.
  - Multiply the basis for depreciation by this fraction (c divided by d).
- Cost .....\$17,000  
 Salvage..... 2,000  
 Basis for depreciation .....\$15,000

Year	Annual Computation			Annual Depreciation
	Basis for Depreciation		Ratio	Allowance
1st	\$15,000	x	$5/15 =$	\$5,000
2nd	\$15,000	x	$4/15 =$	\$4,000
3rd	\$15,000	x	$3/15 =$	\$3,000

**USED ASSET**

Facts: Cost .....\$46,000  
 Salvage value ..... 1,000  
 Estimated useful life .....15 years  
 Provider used the asset (prior to entrance into program) for.....10 years

Annual depreciation is computed as follows:

- Determine the number of remaining years of useful life (15 years minus 10 years = 5 years of remaining useful life).
- Add each number of the remaining years of useful life (5 years =  $1+2+3+4+5=15$ ).
- Use the sum 15 as the denominator of the fraction.
- Each year, for the numerator of the fraction, use the remaining years of useful life including the year in which depreciation is taken. This means using each number in b. above in inverse order (5,4,3,2,1), i.e., 5 for the first year under the program, 4 for the second year under the program, 3 for the third year under the program, etc.

- e. Determine the basis for depreciation as follows:

Cost		\$46,000
Deduct: Salvage value		<u>1,000</u>
Balance		\$45,000
Deduct: Accumulated depreciation under straight-line method for 10 years		
	$\$45,000 \times \frac{10 \text{ years}}{15 \text{ years}}$	<u>\$15,000</u>

- f. Multiply the basis for depreciation by (e) by the fraction (d divided by c) to determine annual depreciation.

Annual Computation				Annual Depreciation
Year	Basis		Ratio	Allowance
1st	\$15,000	x	5/15	\$5,000
2nd	\$15,000	x	4/15	\$4,000
3rd	\$15,000	x	3/15	\$3,000

116.3 Declining Balance Method.--Under this method, the annual allowance is computed by multiplying the undepreciated balance of the historical cost of the asset by a uniform rate up to double the straight-line rate. Where the declining balance method is justified for assets acquired after July 1970, the declining balance rate cannot exceed 150 percent of the straight-line rate. (See section 116.C.) Salvage value is not considered in computing the depreciation allowance. However, under this method, the asset should not be depreciated below the estimated salvage value.

#### NEW ASSET

Facts: Cost		\$17,000
Salvage value		2,000
Estimated useful life		5 years
Rate to be used	Double the straight-line rate: $2 \times 20\% = 40\%$ .	

Annual Depreciation is computed as follows:

Year	Undepreciated Balance		Ratio	Annual Depreciation Allowance
1st	\$17,000	x	40% =	\$6,800
2nd	10,200	x	40% =	\$4,080
3rd	6,120	x	40% =	\$2,448

USED ASSETS

Facts:	Cost	\$46,000
	Salvage value	1,000
	Estimated useful life	15 years
	Provider used the asset (prior to entrance into the program)	10 years
	Double the straight-line rate to be used under the program.	

Annual depreciation is computed as follows:

- a. Determine the number of remaining years of useful life. (15 years minus 10 years = 5 years of remaining useful life)
- b. Determine the straight-line rate for the remaining years of useful life ( 100% / 5 yrs. = 20%)
- c. Double the straight-line (2 x 20% = 40%).
- d. Determine the basis for depreciation as follows:

Cost	\$46,000
Deduct: Salvage value	<u>1,000</u>
Balance	\$45,000
Deduct: Accumulated depreciation under straight-line method for 10 years	

\$45,000 x	$\frac{10 \text{ years}}{15 \text{ years}}$	<u>\$30,000</u>
------------	---	-----------------

Balance	\$15,000
Salvage value	<u>1,000</u>
Basis for depreciation (or unrecovered cost in first year under the program)	<u>\$16,000</u>

- e. Multiply each year's undepreciated balance (or unrecovered cost) by 40% (Note: Do not depreciate the asset below its salvage values).

Year	Undepreciated Balance		Ratio	Annual Allowance Depreciation
1st	\$16,000	X	40%	\$5,400
2nd	\$ 9,600	X	40%	\$3,840
3rd	\$ 5,760	X	40%	\$2,304
4th	\$ 3,456	X	40%	\$1,382
5th	\$ 2,074	X	40%	\$ 830

## 118. DETERMINING DEPRECIATION IN YEAR OF ACQUISITION AND DISPOSAL

For depreciable assets (except for buildings, both old and new, acquired and put into use for patient care in cost reporting periods beginning on or after April 1, 1983), the following policy applies: the methods shown below are acceptable for computing first-and last-year depreciation. Any other method must be approved by the intermediary with the request made by the provider before the end of the first month of the cost reporting period to which the other method is intended to apply. Whatever method is adopted, it is to be applied to assets subsequently acquired. However, providers are allowed a one-time opportunity under the program to change their method of computing first-and last-year depreciation. Any change in method would apply to all assets acquired subsequent to the change. A provider cannot elect a change for assets of only a certain type or class. The provider must notify the intermediary of the one-time change before the end of the first month of the cost reporting period to which the change is intended to apply.

A. Time Lag Alternatives.--These result in delayed recording of depreciation after the actual date of acquisition. However, they provide the convenience of updating detailed, supportive accounting records at the end of certain extended time intervals.

1. Up to Six Months Time Lag.--Assets acquired during the first six months of the reporting year are subject to depreciation beginning with the first day of the seventh month of the reporting year.

Assets acquired during the second six months of the reporting year are subject to depreciation beginning with the first day of the subsequent reporting year.

Depreciation on disposal is based on the portion of the year in which the asset is disposed. If the asset is disposed of in the first half of the reporting year, one-half year's depreciation is taken. If the asset is disposed of in the second half of the year, a full year's depreciation is taken.

2. Up to One Year Time Lag.--Assets acquired during the reporting year become effective for depreciation on the first day of the subsequent reporting year. In the year of disposal a full year's depreciation is taken.

NOTE: A variation of the above methods by the use of a quarterly or monthly basis for determining depreciation in the first year and the year of disposal would be acceptable.

B. Half Year Depreciation.--One-half year depreciation is taken in the year of acquisition regardless of acquisition date and one-half year depreciation is taken on disposition regardless of disposition date.

C. Actual Time Depreciation.--Depreciation for the first reporting period is based on the length of time from the date of acquisition to the end of the reporting year. Depreciation on disposal is based on the length of time from the beginning of the reporting year in which the asset was disposed to the date of disposal.

Buildings, both old and new, acquired and put into use for patient care in cost reporting periods beginning on or after April 1, 1983, must be depreciated on the actual time basis. For buildings acquired and put into use for patient care in cost reporting periods beginning prior to this date, any of the above methods are acceptable. New providers participating in the Medicare program after March 31, 1982, are not subject to the Actual Time Depreciation method for buildings acquired and put into use for patient care prior to April 1, 1983.

#### 120. CHANGE OF DEPRECIATION METHOD

Prior to August 1970, a provider could have changed from the straight-line method to an accelerated method, or vice versa, on a prospective basis upon advance approval from the intermediary with the request being made before the end of the first month of the prospective reporting period. Only one such change with respect to a particular asset could have been made by a provider.

After July 1970, a provider using an accelerated method of depreciation or the optional method may change only to the straight-line method. Such a change may be made without intermediary approval, and the basis for depreciation is the undepreciated cost reduced by the salvage value. Depreciation after a change is based on the remaining years of useful life. Once the straight-line method of depreciation is selected for a particular asset, an accelerated method may not be established for that asset.

#### 122. CHANGING ESTIMATED USEFUL LIFE

A change in the estimated useful life may be made when clear and convincing evidence justifies a redetermination of the useful life used by the provider. Such a change must be approved by the intermediary in writing, and the factors cited in §104.17 are applicable in making such redeterminations of useful life. If the request is approved, the change is effective with the reporting period immediately following the period in which the provider's request is submitted for approval.

**Where the estimated useful life of an asset expires during the provider's participation in the program, no further redeterminations of the asset's useful life may occur and no further depreciation may be claimed by the provider.**

A. Assets Acquired After Provider's Entrance into Program.--When the estimate of the useful life of an asset is changed, the undepreciated balance as of the date of change is depreciated over the new remaining useful life under the straight-line and sum-of-the-years' digits methods. For an asset depreciated under the declining-balance method, the undepreciated balance as of the date of change is depreciated by applying a percentage based on the entire revised useful life of the asset. The following examples illustrate how the new annual depreciation is computed under the accelerated methods of depreciation.

##### EXAMPLE #1--Declining balance method.

An asset costing \$10,000 and having an estimated useful life of 10 years has been depreciated for 6 years at the declining-balance rate of 20%. The depreciation accumulated during the 6 years is \$7,378.60, and the undepreciated balance is \$2,621.40.

At the end of the 6th year, it is determined that the remaining useful life is 8 years. Accordingly, future depreciation must be computed as though the estimate of useful life was originally determined to be 14 years. The applicable depreciation rate would be 14-

2/7% (twice straight-line rate of 7-1/7%). This rate would be applied to the undepreciated balance. Thus, for the 7th year, the depreciation would be 14-2/7% times \$2,621.40--or--\$374.49.

**EXAMPLE #2--Sum-of-the-years' digits method.**

An asset having an estimated useful life of 10 years is purchased for \$10,500. Salvage value is estimated at \$500. After 5 years, the accumulated depreciation under the sum-of-the-years' digits method amounts to \$7,272.70; the undepreciated balance of the cost is \$3,227.30. At the beginning of the 6th year, it is determined that the asset has 9 years more of useful life.

Depreciation for the 6th year should be computed as though the 6th year were the first year of life on an asset estimated to have a useful life of 9 years. Accordingly, the depreciation for the 6th year (or first year under the new estimate) would be computed as follows:

Basis for depreciation:	
Unrecovered cost	\$3,227.30
Less: Salvage Value	500.00
Basis for depreciation	<u>\$2,727.30</u>
Sum-of-the-years' digits (1, 2, 3, etc....9) =	45
Depreciation = 9/45 X \$2,727.30 =	<u>\$ 545.46</u>

**B. Assets Acquired Before Provider's Entrance into Program.**--A change in the estimated useful life of an asset that was acquired before the provider's entrance into the program may be made when clear and convincing evidence justifies a redetermination of the useful life used by the provider. As with assets acquired after the provider's entrance into the program, the undepreciated balance as of the date of change is depreciated over the new remaining useful life of the asset. Where a change in the estimate of the useful life of an asset that was acquired before the provider's entrance into the program occurs in the provider's first year of participation in the program, it will be necessary to correct prior years' depreciation for the periods before entrance into the program. If a change in useful life of an asset acquired before a provider's entrance into the program is made after the first year of the provider's entrance into the program, prior years' depreciation is not changed (corrected). The following example illustrates how the correction is computed.

**EXAMPLE #3--**

Facts:

Asset acquired 3 years before entrance into program:	
Historical cost of asset	\$30,500
Estimated remaining useful life at entrance into program	7 years
Estimated salvage value	\$ 500
Straight-line depreciation used under program.	
At beginning of first year under program, it is estimated that asset has 12 more years of useful life.	

**Computation of depreciation for the first year under program**

New estimated useful life	15 years
3 years before program	
<u>12</u> years more of useful life	
<u>15</u>	

Historical cost			\$30,500
Depreciation accumulated prior to program			
3 years x $\frac{(\$30,500 - \$500 \text{ salvage value})}{15 \text{ years}}$			<u>\$ 6,000</u>
Adjusted historical cost			\$24,500
Deduct: Salvage value			<u>500</u>
Adjusted basis for depreciation under the program			\$24,000
Annual depreciation under the program			
		<u>\$24,000</u>	=
12 years of useful life under program			<u>\$2,000</u>
Depreciation for the first year under the program			
and annually thereafter is			<u>\$ 2,000</u>

Adjusted historical cost-----	\$24,500
Deduct: Salvage value-----	<u>500</u>
Adjusted basis for depreciation	
under the program-----	24,000
Annual depreciation under the program	
\$24,000 =	<u>\$ 2,000</u>
Depreciation for the fourth year and annually	
thereafter is-----	<u>\$ 2,000</u>
Correction of prior years' depreciation	
Original continued useful life-----	<u>10 years</u>
Historical cost-----	<u>\$30,500</u>
Depreciation accumulated prior to program on	
basis of estimate of 10 years' useful life	
3 years x $\frac{(\$30,500 - \$500)}{10 \text{ years}}$	<u>9,000</u>

Adjusted historical cost-----	\$21,500
Deduct: Salvage value-----	<u>500</u>
Adjusted basis for depreciation under the	
program-----	\$21,000
Depreciation that was taken under the	
program in four years	
4 years x $\frac{\$21,000}{7 \text{ years}}$	<u>\$12,000</u>
Corrected depreciation for four years under	
the program based on estimated useful life	
of 15 years ( 4 years x \$2,000 annual	
depreciation)-----	<u>8,000</u>
Reduction of prior years depreciation under	
the program-----	<u>\$ 4,000*</u>

**124. OPTIONAL ALLOWANCE FOR DEPRECIATION BASED ON A PERCENTAGE OF OPERATING COST**

For all depreciable assets acquired before January 1, 1966, the provider, at its option, may at the time it enters the program choose an allowance for depreciation based on a percentage of operating costs. This option is available to any provider, regardless of whether or not the provider has historical cost records of these assets. However, a provider that has elected to use actual depreciation cannot at a later date switch to the optional allowance.

The operating costs to be used are the lower of the provider's 1965 operating costs or the provider's current year's allowable costs. The percentage to be applied is 5 percent for all reporting periods beginning in the year 1966-67 (July 1, 1966-June 30, 1967); 4.5 percent for all reporting periods beginning in the year 1967-68 (July 1, 1967-June 30, 1968), with each percentage being uniformly reduced by one-half percent each succeeding year.

The allowance based on operating costs is in addition to regular deprecation on assets acquired after 1965. However, when the optional

allowance is selected, the combined amount of such allowance on pre-1966 assets and the straight line depreciation on assets acquired after 1967, and the estimated depreciation on a straight-line basis on all rented assets used during the current year may not exceed 6 percent of the provider's adjusted allowable cost for the current year. In applying this limitation, if the actual depreciation claimed on post-1965 assets is on an accelerated basis, it must be converted to a straight-line basis only for use in computing this limitation. the actual depreciation claimed on an accelerated basis is properly includable in allowable costs.

**124.1 Definitions.--**

A. Operating Costs.--Operating costs are the total costs, related to patient care, incurred by the provider in operating the institution or facility.

B. 1965 Operating Costs.--1965 Operating costs are the provider's operating costs incurred in the provider's fiscal year beginning in the period 8/1/64--7/31/65 without adjustment to Medicare's principles of reimbursement for provider costs. When the 1965 operating costs are used as a base for determining the optional allowance for depreciation, such costs must be adjusted to exclude the estimated depreciation on rented depreciable type assets or the rental charge for such assets whichever is lower; and in addition, the 1965 operating cost must not include any actual depreciation, on amount in lieu of specific recognition of other costs, "a plus factor," or return on equity capital.

C. Allowable Costs.--Allowable costs are those costs included in cost reimbursement under the Medicare principles of reimbursement for provider costs. When the current year's allowable costs are used as a base for the optional allowance for depreciation, they should be adjusted to exclude (1) any actual depreciation, (2) the lesser or rental charges or estimated depreciation on rented depreciable type assets, (3) allowance in lieu of specific recognition of other costs, and (4) return on equity capital. The exclusion of these four items is only for the purpose of computing the optional allowance for depreciation. For other purposes, rental charges and excluded items (1), (3), and (4) are recognized in determining allowable costs and for computing the costs of services rendered to the program beneficiaries during the reporting period.

Where a provider files a short-period report, the allowable costs must be converted to a full year's basis (see example 3) only for the purpose of computing the optional allowance.

124.2 Applicable Percentages.--The percentage to be applied in each reporting year is shown in the following schedule:

Reporting year beginning After but Before	Percentage Allowances
----- 7/1/67	5
6/30/67 7/1/68	4.5
6/30/68 7/1/69	4
6/30/69 7/1/70	3.5
6/30/70 7/1/71	3
6/30/71 7/1/72	2.5
6/30/72 7/1/73	2
6/30/73 7/1/74	1.5
6/30/74 7/1/75	1
6/30/75 7/1/76	2
6/30/76 7/1/77	0

124.3 Computation of Optional Allowance for Depreciation.--The following illustrates the determination of the optional allowance for depreciation based on operating costs:

**EXAMPLE 1**

Facts:

The provider keeps its records on a calendar year basis. The current year's actual allowable cost and the actual operating costs for 1965 do not include any actual depreciation or rentals on depreciable type assets. The current year's allowable costs has been adjusted to remove any allowance in lieu of specific recognition of other costs and return on equity capital.

Computation

First Reporting Period (1/1/66-12/31/66)	
Adjusted current year's allowable cost----	<u>\$ 1,100,000</u>
Operating cost for 1965 <sup>1</sup> -----	<u>\$1,000,000</u>
Percent for determining the allowance----	5%
Allowance (5% x \$1,000,000)-----	<u>\$ 50,000</u>

<sup>1</sup>1965 operating cost was used in computing the allowance for depreciation because it was lower than 1964 adjusted allowable cost.

Second Reporting (1/1/67-12/31/67)

Adjusted current year's allowable cost----	<u>\$1,200,000</u>
Operating cost for 1965 <sup>1</sup> -----	<u>\$1,000,000</u>
Percent for determining the allowance <sup>2</sup> ---	5%
Allowance (5% x \$1,000,000)-----	<u>\$ 50,000</u>

<sup>1</sup>1965 operating cost was used in computing the allowance for depreciation because it was lower than 1967 adjusted allowable cost.

<sup>2</sup>Since the reporting period began during the year 1966-67 (July 1, 1966 June 30, 1967) 5 percent is the percentage used.

Third Reporting Period (1/1/68-12/31/68)

Operating cost for 1965-----	<u>\$1,000,000</u>
Current year's adjusted allowable cost <sup>1</sup> --	<u>\$ 900,000</u>
Percent for determining the allowance <sup>2</sup> --	4.5%
Allowance (42% x \$900,000)-----	<u>\$ 40,500</u>

<sup>1</sup>The current year's adjusted allowable cost was used in computing the allowance for depreciation because it was lower than 1965 operating cost.

<sup>2</sup>Since the reporting period began during the year 1967-68 (July 1, 1967-June 30, 1968) 4.5 percent is the percentage to be used.

**EXAMPLE 2**

Facts:

The provider keeps its records on a calendar year basis. The current year actual allowable cost and the 12 actual operating cost for 1965 did not include any actual depreciation, nor return on equity capital. However, both

1965 and the current year's costs have been adjusted to exclude depreciation (\$3,000 for 1965, \$2,000 for the current year) on rented depreciable type assets. The current year's allowable cost has also been adjusted to remove the allowance in lieu of specific recognition of other costs and return on equity capital.

Computation

First Reporting Period (1/1/66-12/31/66)	
Adjusted current year's allowable cost----	<u>\$ 1,100,000</u>
Adjusted operating cost for 1965 <sup>1</sup> ----	<u>\$1,000,000</u>
Percent of determining the allowance-	5%
Allowance (5% x \$1,000,000)-----	<u>\$ 50,000</u>
Less: Estimated depreciation for depreciable type assets on which rental of \$6,000 is paid in 1966---	<u>\$ 3,000</u>
Adjusted allowance-----	<u>\$ 47,000</u>

<sup>1</sup>1966 adjusted operating cost was used in computing the allowance for depreciation because it was lower than 1966 adjusted allowable cost.

**EXAMPLE 3**

Facts:

The provider keeps its records on a calendar year basis. The provider's first report will be a short period one of six months, July 1, 1966-December 31, 1966. The current year's actual allowable cost and the actual operating costs for 1965 do not include any actual depreciation or rentals on depreciable type assets. The current year's allowable cost has been adjusted to remove the allowance in lieu of specific recognition of other costs.

Computation

First Reporting Period (7/1/66--12/31/66)	
Adjusted current year's allowable cost (6 months)-----	<u>\$ 575,000</u>
Adjusted current year's allowable cost converted to a 12-month period (2 x \$575,000)-----	<u>\$ 1,150,000</u>
Operating Cost for 1965 <sup>1</sup> -----	<u>\$1,000,000</u>
Percent for determining allowance---	5%
Allowance (5% x \$1,000,000)-----	<u>\$ 50,000</u>

<sup>1</sup>1965 operating cost was used on computing the allowances for depreciation because it was lower than the adjusted allowable costs covering a 12-month period.

Second Reporting Period (1/1/67--12/31/67)

Adjusted current years allowable cost----	<u>\$1,200,000</u>
Adjusted operating cost for 1965 <sup>1</sup> -----	<u>\$1,000,000</u>
Percent for determining the allowance----	5%
Allowance (5% x \$1,000,000)-----	<u>\$ 50,000</u>
Less: Estimated depreciation for depreciable type assets on which a rental of \$5,000 is paid in 1967-----	<u>1,000</u>
Adjusted allowance-----	<u>\$ 47,000</u>

<sup>1</sup>1967 adjusted operating cost was used in computing the allowance for depreciation because it was lower than the 1967 affected allowable costs.

**124.4 Limitation.**—The optional allowance only-not the actual depreciation-is subject to a limitation based on the provider's total allowable operating cost for the current year. To determine this limitation, compute the sum of (a) The actual depreciation

claimed for period 1965 assets computed on a straight-line basis, (b) "the optional allowance based non a percentage of operating costs," and (c) estimated depreciation on depreciable type rented assets used in the current year. If this sum exceeds 6 percent of the provider's current year's adjusted allowable cost (allowable cost reduced by any depreciation claimed, the estimated depreciation on rented depreciable type assets, allowance in lieu of specific recognition of other costs, and return on equity capital), the optional allowance for depreciation must be reduced by the amount of the excess. In applying this limitation if the actual depreciation is on an accelerated basis, it must be converted to a straight-line basis only for use in calculating this limitation.

Where the provider files a short-period report, the period's allowable costs, after adjustment to exclude the 4 items mentioned above, must be converted to a full year's basis (see Example 3). This if the short-period report is for 8 months, the adjusted allowable costs should be increased by 50%; if the sort period is for 9 months, the adjusted allowable cost should be increased by 33 1/3%, etc. In addition, the actual depreciation computed on a straight-line basis as well as the estimated depreciation on rented depreciable type assets must be converted to a 12-month or full year's basis.

The following illustration demonstrates how the limitation is determined:

**EXAMPLE 4**

*Facts:*

The provider keeps its records on a calendar year basis. For its first report, the provider will use a 6 month's period. The current year's actual allowable cost and the actual operating cost for 1965 have been adjusted to exclude actual depreciation, the estimated depreciation on rented depreciable type assets, allowance in lieu of specific recognition of other costs, and return on equity capital.

Adjusted operating cost for 1965-----	\$1,000,000
Adjusted allowable operating cost for the last 6 months of 1966-----	\$ 550,000
In 1966, assets were acquired which produced for 1966 a straight-line depreciation of-----	\$ 18,000
Estimated depreciation for the year on rented assets used in 1966-----	\$ 4,000
Estimated annual depreciation on assets rented for which an annual rental of \$5,000 is paid\$	3,000

Gross optional allowance: 5% of adjusted 1965 operating cost (\$1,000,000)<sup>1</sup>-----

*Computation of the Optional Allowance  
First Reporting Period (7/1/66)--12/31/66)*

Rev. 63	
Adjusted allowable costs for the last 6 months of 1966 converted to a 12 month basis (2 x \$550,000)-----	<b>\$1,100,000</b>
Less: Estimated depreciation on assets rented	<b>3,000</b>
Gross Allowance-----	<b>\$ 47,000</b>

Rev. 63

Add: Estimated depreciation for the year on rented assets used in 1966-----	<b>4,000</b>
Straight-line depreciation on post 1965 assets for 12 months-----	<b>18,000</b>
Total-----	<b>\$ 69,000</b>
6% x \$1,100,000)-----	<b>66,000</b>
Deduction in allowance-----	<b>\$ 3,000</b>
Gross Allowance-----	<b>\$ 47,000</b>
Less: Reduction for excess of 6% limitation	<b>\$3,000</b>
Net optional allowance for the year-----	<b>\$ 44,000</b>
Net optional allowance converted to a 6 month period (\$44,000 ÷ 2)-----	<b>\$ 22,000</b>

<sup>1</sup>The adjusted 1965 operating cost is used because it is lower than the adjusted allowable cost converted to a 12 month period.

*Second Reporting Period (1/1/67--12/31/67)*

*Facts:*

Adjusted allowable cost for 1967-----	<b>\$1,150,000</b>
Adjusted operating cost for 1965-----	<b>1,000,000</b>
Percent for determining the allowance----	<b>5%</b>
Straight-line depreciation on assets acquired after 1965-----	<b>\$ 20,000</b>
Estimated depreciation on \$7,000 rental of depreciable type assets used in 1967-----	<b>4,000</b>
Estimated depreciation on depreciable assets rented on which annual rental of \$5,000 is paid---	<b>3,000</b>

*Computation:*

<i>Gross Optional Allowance</i>	
5% times adjusted 1965 operating cost (5% x \$1,000,000)-----	\$ 50,000
Less: Estimated depreciation on depreciable assets rented-----	<b>3,000</b>
Adjusted allowance-----	<b>\$ 47,000</b>
Add: Straight-line depreciation on post-1965 assets-----	<b>20,000</b>
Estimated depreciation on depreciable rented assets used in 1967-----	<b>4,000</b>
Total-----	<b>\$ 71,000</b>
Less: 6% of adjusted 1967 allowable operating cost-----	<b>\$ 69,000</b>
Deduction to adjusted allowance-----	<b>\$ 2,000</b>
Net allowance to be included in allowable cost:	
Adjusted allowance-----	<b>\$ 47,000</b>
Less: Deduction to adjusted allowance	<b>2,000</b>
Net allowance-----	<b>\$ 45,000</b>



## 126. CHANGE FROM OPTIONAL ALLOWANCE TO ACTUAL DEPRECIATION

A provider that elects the optional allowance for depreciation may at any time before 1976 change to actual depreciation on its pre-1966 depreciable assets. When a provider switches to actual depreciation, it can no longer elect the optional allowance.

After July 1970, a provider using the optional allowance for depreciation may change only to the straight-line method of depreciation. Such a change may be made without intermediary approval. When a provider changes to straight-line depreciation, the depreciation accumulated to the date of change is determined in the same manner as accumulated depreciation is determined for use assets when a provider enters the program. Upon disposition of the asset, the determination of gain or loss is made on the basis of historical cost depreciation for the actual useful life of the asset.

### 130. DISPOSAL OF ASSETS

Depreciable assets may be disposed of through sale, scrapping, trade-in, donation, exchange, demolition, abandonment or involuntary conversions such as condemnation, fire, theft or other casualty. If the disposal of a depreciable asset results in a gain or loss, an adjustment may be necessary in the provider's allowable cost (see §104.10.B through §104.10.E.). The amount of gain included in the determination of allowable cost is limited to the amount of depreciation previously included in allowable costs. The amount of loss to be included is limited to the undepreciated basis of the asset permitted under the program. When an asset has been retired from active service but is being held for standby or emergency services, depreciation may continue to be taken on such assets.

In no case, however, can gain or loss be computed on the retired asset until the asset is actually disposed of. A gain or loss on the disposal of depreciable assets has no effect on a proprietary provider's equity capital for prior years. If the sale or scrapping occurs on or after December 1, 1997, no gain or loss is recognized (see §104.10.E).

### 132. GAINS AND LOSSES ON DISPOSAL OF DEPRECIABLE ASSETS (EXCLUDING INVOLUNTARY CONVERSIONS)

A. Gains and losses on the disposition of depreciable assets are includable, as applicable, either in computing allowable cost or in computing the adjustment to Medicare reimbursable cost, depending upon the manner of disposition of the asset, the date of the disposal, and the amount of the net depreciation adjustment. Any type of asset may be disposed of by sale. Scrapping, as defined in §104.19, however, is limited to tangible personal properties which (1) can be physically removed from the provider's premises, (2) are no longer useful for their intended purpose, and (3) are only salable for their scrap or junk value. Structures such as buildings which cannot easily be moved are usually demolished or abandoned when useless. However, certain building components such as doors, fixtures and elevators that can be detached from the building shell can be either demolished or scrapped. The manner of disposition is the criterion, not the asset type.

1. Bona Fide Sale or Scrapping.--Gains and losses realized from a bona fide sale or scrapping of a depreciable asset before December 1, 1997 are includable as an adjustment of depreciation in the period of disposal under the criteria in §132.3.A, or if those criteria are not met, includable as an adjustment to Medicare reimbursable costs under §132.3.B. or C. based on an allocation of the gains and losses to periods during which depreciation was allowed under the program for the disposed assets. Gains and losses may be recognized on a bona fide sale before December 1, 1997 which occurs while the provider is either participating in the program or within 1 year immediately following the date on which the provider terminates participation in the Medicare program. However, gains and losses are recognized only on a scrapping before December 1, 1997, that occurs while the provider is participating in the program. If several assets are sold for a lump sum sales price, the gain or loss on the sale of each depreciable asset must be determined by allocating the lump sum sales price among all the assets sold on the basis of the fair market value of each asset at the time of sale. If the buyer and seller cannot agree on an allocation of the sales price, or if they do agree but there is insufficient documentation of the current fair market value of each asset, the intermediary for the selling provider shall require an appraisal by an independent appraisal expert to establish the fair market value of each asset and shall make an allocation of the sales price in accordance with the appraisal.

2. Exchange, Trade-in or Donation--Gains and losses realized from the trade-in, donation, or exchange of depreciable assets are not included in the determination of allowable cost. (See section 104.11.)
3. Demolition or Abandonment--

- a. Treatment of Gains and Losses on a Depreciable Asset as

Defined in Section 104.21 or 104.22 --Losses on demolition include the demolition cost incurred by the provider for razing and removal of the asset, less any salvage value recovered by the provider. In situations where a provider is both selling or scrapping while abandoning or demolishing other assets, the provisions for treatment of a gain or loss from a sale or scrapping will be applied separately from those for treatment of a gain or loss from abandonment or demolition.

If the aggregate loss (net depreciation adjustment) from all demolitions and abandonments during the cost reporting period:

(1) does not exceed \$5,000, the loss is allowed in the period of disposal (see section 132.3A(2)),

(2) exceeds \$5,000 and each asset is at least 80 percent depreciated as computed under the straight-line method at the date of disposition, the loss is allowable as stated in section 132.3B, or

(3) exceeds \$5,000, and each demolished or abandoned asset is not 80 percent depreciated as computed under the straight-line method at the date of disposition, it must be capitalized as a deferred charge and amortized as follows:

(a) Abandonment or Demolition Approved by the State Health Planning and Development Agency (SHPDA), or The Regional Office--The net loss realized must be capitalized as a deferred charge and amortized over the remaining life of the demolished or abandoned asset, or at the rate of \$5,000 per year, whichever is greater. If no SHPDA exists or if such agency is unable or unwilling to perform this function, the provider must submit a request for approval to the intermediary. After reviewing the request, the intermediary shall submit the request along with its recommendation to the regional office for its approval.

(b) Abandonment or Demolition Not Approved by SHPDA or the Regional Office--The net loss realized is not allowable unless the demolished or abandoned asset is replaced. If replaced, the net loss realized must be capitalized as a deferred charge and then amortized over the estimated useful life of the replacement asset or at the rate of \$5,000 per year, whichever is greater.

b. Demolition of an Asset for the Purpose of Preparing Land for Future Sale--

The net demolition cost incurred by the provider (razing and removal costs less salvage recovered) on a depreciable asset shall be considered a capital expenditure and added to the historical basis of the land. If a provider purchases land on which there is a building, no depreciation is reimbursable unless the building is used in providing patient care. If the building is demolished, the entire purchase price and demolition cost is considered the historical cost of the land. However, if the building is used for patient care, but demolished within 5 years of purchase, the entire purchase price less allowed depreciation, plus demolition cost shall be considered the historical cost of the land.

4. Sale of a Replacement or Restored Asset--If a provider sells a replacement or restored asset while participating in the Medicare program or within 1 year immediately following its date of termination from the Medicare program, the unrecovered loss entered on the books of the provider as a deferred charge in accordance with 132.A.3(a)(3), will not be included in determining the gain or loss realized from the sale of the replacement or restored asset. However, if the sale of such asset is made to a related organization as defined in section 1002.1 and the purchasing organization continues as a provider in the Medicare program, the remaining deferred charge representing the unrecovered depreciable basis of the demolished or abandoned asset shall continue to be amortized over the remaining expected useful life of the replacement or restored asset. If the sale is made to an unrelated provider, further amortization of the deferred charge is not allowed.

5. Involuntary Conversions.--The treatment of gains and losses realized from the involuntary conversion, i.e., casualty losses, is specified in section 133.

6. Unrecovered Losses-Equity Capital Treatment.--The unrecovered loss entered on the books of the provider as a deferred charge in situations involving demolitions or casualty losses, is not includable in the computation of equity capital (see section 1218.13).

B. Where a provider terminates participation in the program after July 1970, disposes of all of its depreciable assets, AND is subject to recovery of accelerated depreciation in accordance with the provisions of § 136, then the methodology contained in § 132ff. will be followed to determine the adjustment to Medicare reimbursable cost. Where a provider has a decrease in HI utilization that meets the requirements for recovery of accelerated depreciation as described in § 136, then such recovery must be made first in accordance with the provisions of § 136 before computing the gain or loss. Where recovery has been made under § 136, the adjusted book value is taken into account in the calculation of the net depreciation adjustment applicable to subsequent disposals of such assets.

C. The net depreciation adjustment on the disposition of depreciable assets includes: (1) the amount of the gain or loss, (2) indirectly, the depreciation adjustment on those assets acquired prior to entrance into the program, and (3) depreciation taken in excess of straight-line depreciation for a provider that disposes of all of its depreciable assets and is subject to recovery of accelerated depreciation in accordance with the requirements described in § 136. With respect to a gain on disposition, the net depreciation adjustment will be limited to the amount of depreciation accumulated for that asset under the program.

The methods to determine the net depreciation adjustment are contained in §§ 132.1 and 132.2. The methods to allocate the net depreciation adjustment are contained in § 132.3. Finally, the methods to determine the adjustment to Medicare reimbursable cost are contained in § 132.4.

D. Where an asset acquired in a non bona fide sale is subsequently disposed of, the gain or loss on disposition is based on the historical cost of the asset in the hands of the seller last owning the asset as a result of a bona fide acquisition and the calculation of gain or loss shall include the accumulated depreciation taken under the program by both the seller and the purchaser in the non bona fide sale.

E. Where a provider has elected to be reimbursed for depreciation using the optional allowance and did not subsequently change to actual depreciation prior to the disposal of the asset, no gain or loss is recognized upon disposal of the asset. If the provider initially elected the optional allowance but subsequently changed to actual depreciation, gain or loss will be recognized on disposal of the asset and the net depreciation adjustment is applicable to the periods in which actual depreciation is claimed.

132.1 Computation of Net Depreciation Adjustment Upon Disposal of Depreciable Assets Acquired Before the Provider's Entrance Into the Program.--When an asset is disposed of, a recomputation of the net book value based on actual useful life must be made in determining the net depreciation adjustment. The actual useful life will cover the period from date of acquisition to date of disposal. The examples below show the methods used to determine the net depreciation adjustment applicable to years under the program.

Under the procedure used in Example 1 and 2, the actual salvage value (sales price) is deducted from historical cost in determining the basis for depreciation. The basis is allocated to determine the adjusted depreciation applicable to the period under the program. The difference between the adjusted depreciation applicable to that period under the program and the actual depreciation taken during that period is the net depreciation adjustment.

Example 3 shows the computation of the net depreciation adjustment where a provider disposes of its depreciable assets and is subject to recovery of accelerated depreciation in accordance with the requirements described in § 136. The net depreciation adjustment is determined by combining the gain or loss applicable to the period under the program with the depreciation taken in excess of straight-line depreciation.

EXAMPLESFacts Applicable to Examples 1, 2, and 3 Below:

Provider entered the program 7/1/68

Historical cost - 7/1/58	\$330,000
Estimated salvage value	<u>15,000</u>
Amount to be depreciated	<u>\$315,000</u>

Estimated useful life	<u>30 years</u>
-----------------------	-----------------

Actual useful life	
Asset acquired before entrance into the program - 7/1/58	10 years
Useful life under the program - asset sold 6/30/73	<u>5 years</u>
Total actual useful life	<u>15 years</u>

Depreciation taken before entrance into the program - straight-line method

$\frac{(\text{Years - not under the program})}{(\text{Years - estimated useful life})} \frac{10}{30} \times \$315,000 =$	\$105,000
--	-----------

Sales price - 6/30/73	\$183,000
-----------------------	-----------

EXAMPLE 1 - COMPUTATION OF NET DEPRECIATION ADJUSTMENT WHERE  
ACCELERATED DEPRECIATION WAS CLAIMED BY PROVIDER

Historical cost - 7/1/58	\$330,000
Actual salvage value - sales price 6/30/73	<u>183,000</u>
Basis for depreciation	\$147,000

Depreciation adjusted for period not under the program	
$\frac{(\text{Years - not under the program})}{(\text{Years - actual useful life})} \frac{10}{15} \times \$147,000$	<u>98,000</u>

Depreciation adjusted for period under the program	<u>\$49,000</u>
--	-----------------

Depreciation taken under the program-sum-of-the-years' digits method	
$\$315,000 - \$105,000 = \$210,000 \div 210 \text{ units (20 years)} = \$1,000 \times$	
90 units (5 years) =	\$90,000
Depreciation adjusted for the period under the program	<u>49,000</u>
Net depreciation adjustment - Excess depreciation taken	<u>\$41,000</u>

EXAMPLE 2 - COMPUTATION OF NET DEPRECIATION ADJUSTMENT WHERE  
STRAIGHT-LINE DEPRECIATION WAS CLAIMED BY PROVIDER

Historical cost - 7/1/58	\$330,000
Actual salvage value - sales price 6/30/73	<u>183,000</u>
Basis for depreciation	\$147,000
Depreciation adjusted for period not under the program	
$\frac{(\text{Years - not under the program})}{(\text{Years - actual useful life})} = \frac{10}{15} \times \$147,000 =$	98,000
Depreciation adjusted for period under the program	<u>\$49,000</u>
Depreciation taken under the program - straight-line method	
$\frac{(\text{Years - under the program})}{(\text{Years - estimated useful life})} = \frac{5}{30} \times \$315,000 =$	\$52,500
Depreciation adjusted for period under the program	<u>49,000</u>
Net depreciation adjustment - Excess depreciation taken	<u>\$3,500</u>

EXAMPLE 3 - COMPUTATION OF NET DEPRECIATION ADJUSTMENT APPLICABLE  
WHERE A PROVIDER CLAIMED ACCELERATED DEPRECIATION,  
TERMINATES PARTICIPATION IN THE PROGRAM AFTER JULY 1970,  
AND DISPOSES OF ITS DEPRECIABLE ASSETS

<u>Computation of Depreciation in Excess of Straight-Line Depreciation</u>	
Depreciation taken before entrance into the program	\$105,000
Depreciation taken under the program-sum-of-the-years' digits method-- $\$315,000 - \$105,000 = \$210,000 \div 210 \text{ units (20 years)} =$ $\$1,000 \times 90 \text{ units (5 years)} =$	90,000
Total depreciation taken on disposed assets	\$195,000
Depreciation adjusted to straight-line method	
$\frac{(\text{Years - actual useful life})}{(\text{Years - estimated useful life})} = \frac{15}{30} \times \$315,000 =$	157,500
Depreciation in excess of straight-line depreciation	<u>\$37,500</u>
<u>Computation of Gain (or Loss)</u>	
Sales price - 6/30/73	\$183,000
Historical cost - 7/1/58	\$330,000
Depreciation adjusted to a straight-line method	<u>157,500</u>
Unrecovered cost	172,500
Gain on sale	<u>\$ 10,500</u>
<u>Computation of Net Depreciation Adjustment</u>	
Gain applicable to years under the program	
$\frac{(\text{Years - under the program})}{(\text{Years - actual useful life})} = \frac{5}{15} \times \$10,500 =$	\$ 3,500
Depreciation in excess of straight-line depreciation	<u>\$ 37,500</u>
Net depreciation adjustment - Excess depreciation taken	<u>\$ 41,000</u>

132.2 Computation of Net Depreciation Adjustment Upon Disposal of Depreciable Assets Acquired Under the Program.--The methodology for computation of the net depreciation adjustment on depreciable assets acquired under the program is the same as used in § 132.1, in that, for examples 1 and 2 below, the actual salvage value is the sales price which is deducted from historical cost to determine the basis for depreciation. The difference between the basis for depreciation and the actual depreciation taken is the net depreciation adjustment.

Example 3 shows the computation of the net depreciation adjustment applicable where a provider disposes of its depreciable assets and is subject to recovery of accelerated depreciation in accordance with the requirements described in § 136. The net depreciation adjustment is determined by combining the gain or loss with the depreciation taken in excess of straight-line depreciation.

#### EXAMPLES

##### Facts Applicable to Examples 1, 2, and 3 Below:

Historical cost - 7/1/67	\$490,000
Estimated salvage value	<u>25,000</u>
Amount to be depreciated	<u>\$465,000</u>
Estimated useful life	<u>30 years</u>
Actual useful life	6 ½ years
Sales price - 12/31/73	\$300,000

##### EXAMPLE 1 - COMPUTATION OF NET DEPRECIATION ADJUSTMENT WHERE ACCELERATED DEPRECIATION WAS CLAIMED BY PROVIDER

Historical cost - 7/1/67	\$490,000
Actual salvage value - sales price 12/31/73	<u>300,000</u>
Basis for depreciation	<u>\$190,000</u>
Depreciation taken-sum-of-the-years' digits method	
\$465,000 : 465 units (30 years) = \$1,000 per	
unit x 177 units (6 ½ years) =	\$177,000
Basis for depreciation	<u>190,000</u>
Net depreciation adjustment - Additional	
depreciation allowed the provider	<u>(\$ 13,000)</u>

**EXAMPLE 2:** Computation of Net Depreciation Adjustment Where Straight Line Depreciation Was Claimed by the Provider.

Historical cost - 7/1/67	\$490,000
Actual salvage value - sales price - 12/31/73	<u>300,000</u>
Basis for depreciation	<u>\$190,000</u>
Depreciation taken - straight-line method \$465,000 ) 30 (years) = \$15,500 per year x 6 2 years =	\$100,750
Basis for depreciation	<u>190,000</u>
Net depreciation adjustment - additional depreciation allowed the provider	<u>(\$ 89,250)</u>

**EXAMPLE 3:** Computation of Net Depreciation Adjustment Applicable Where a Provider Claimed Accelerated Depreciation, Terminates Participation in the Program After July 1970, and Disposes of its Depreciable Assets.Computation of Depreciation in Excess of Straight-Line Depreciation

Depreciation taken-sum-of-the-years' digits method \$465,000 ) 465 units (30 years) = \$1,000 per unit \$1,000 x 177 units (6 2 years) =	\$177,000
Depreciation adjusted to straight-line method (Years - actual useful life) $\frac{6 2}{30}$ x \$465,000 =	<u>100,750</u>
Depreciation in excess of straight-line depreciation	<u>\$76,250</u>

Computation of Gain (or Loss)

Sales price - 12/31/73	\$300,000
Historical cost - 7/1/67	\$490,000
Depreciation adjusted to a straight-line method	<u>100,750</u>
Unrecovered cost	<u>389,250</u>
Gain (or loss) on sale	<u>(\$ 89,250)</u>

Computation of Net Depreciation Adjustment

Loss on sale	(\$ 89,250)
Depreciation in excess of straight-line depreciation	<u>76,250</u>
Net depreciation adjustment	<u>(\$ 13,000)</u>

**EXAMPLE 4:** Computation of Net Depreciation Adjustment After a Provider Becomes Subject to the Prospective Payment System for Hospital Inpatient Capital-Related Costs (Capital PPS)

## Facts:

Historical costs - 12/31/87	\$490,000
Estimated salvage value	\$ 25,000
Amount to be depreciated	\$465,000
Estimated useful life	30 years
Actual useful life	6 years
Sales price - 12/31/93	\$300,000

## Computation of net depreciation

Historical cost- 12/31/87	\$ 490,000
Actual salvage value -Sales price -12/31/93	<u>300,000</u>
Recomputed basis for depreciation (Straight line method - \$190,00 basis @ 6 years or \$31,667 per year)	\$ 190,000
Depreciation taken-(straight line method \$465,000 basis @30 years or \$15,500 per year for 6 years)	\$ 93,000
Recomputed basis for depreciation	\$190,000
Less depreciation taken	<u>- 93,000</u>
Net depreciation adjustment- additional depreciation allowed the provider	\$ 97,000

Allocation of net depreciation adjustment to each reporting period before and after the effective date of capital PPS:Fully prospective provider.

Fiscal Year Ending	Actual Depreciation Taken	Recomputed Depreciation	Loss On Sale	Net Depreciation Adjustment
12/31/88	\$15,500	\$31,667	\$16,167	(\$16,167)
12/31/89	15,500	31,667	16,167	( 16,167)
12/31/90	15,500	31,667	16,167	( 16,167)
12/31/91	15,500	31,667	16,167	( 16,167)
12/31/92	15,500	31,667	16,167	( 16,167)
12/31/93	15,500	31,667	16,167	( 16,167)

Adjustment to reimbursable cost before and after the effective date of capital PPS:Facts Applicable to Example.

Fiscal Year Ending	Total Allowable Cost	HI Allowable Cost	Percent HI Cost
12/31/88	\$640,000	\$320,000	50%
12/31/89	630,000	252,000	40
12/31/90	600,000	120,000	20
12/31/91	580,000	104,000	18
12/31/92	570,000	85,000	15
12/31/93	550,000	55,000	10

Fiscal Year	Total Allowable Cost	Part B Allowable Cost	Percent Part B Cost
12/31/92	\$570,000	\$39,900	7
12/31/93	550,000	33,000	6

Computation of adjustment to reimbursable cost.

Fiscal Year	HI	Percent Part B Cost	Percent Part B Cost	Net Depreciation Adjustment	Adjustment To HI Reimbursable Costs
12/31/88		50%		(\$16,167)	(\$8,084)
12/31/89		40		( 16,167)	( 6,467)
12/31/90		20		( 16,167)	( 3,233)
12/31/91		18		( 16,167)	( 2,910)
12/31/92		7%		( 16,167)	( 1,132)
12/31/93		6		( 16,167)	( 970)
<b>Total adjustment</b>					<b>(\$22,796)</b>

132.3 Allocation of Net Depreciation Adjustments.--A provider will allocate its total net depreciation adjustments as determined in §§132.1 and 132.2 in accordance with the particular circumstances of either A, B, or C below. Where a provider does not have the depreciation or Medicare utilization information that is contained in the cost reports and is needed for the allocation or determination of adjustment to reimbursable cost for years prior to the 5-year limitation on retention of records, the provider will request such records from the intermediary. **Where the intermediary does not have such records, the provider must use an average of Medicare utilization for the available years to be applied to the years that are not available.**

A. Allocation Permitted in the Year of Disposal.--A provider shall reflect the net depreciation adjustment as an adjustment of depreciation in the year of disposal where either:

1. The HI utilization, based on cumulative total of Medicare covered days for all reporting periods in which depreciation on the asset disposed of was claimed under the Medicare program, is less than 5 percent of the cumulative total of inpatient days in the facility (certified area only) for the same reporting periods; or

2. The net depreciation adjustments applicable to all disposals of depreciable assets within the cost reporting period total \$5,000 or less.

B. Allocation Where Provider Is Not Subject to Recovery of Accelerated Depreciation.--Where a provider is not subject to recovery of accelerated depreciation in accordance with the provisions of §136; when the conditions of paragraph A of this section are not met; and when in the case of demolished or abandoned assets, the assets are at least 80 percent depreciated, the provider will allocate the net depreciation adjustment to each reporting period based on the ratio of the total depreciation allowed on the disposed assets in each reporting period to the total depreciation applicable to such assets for all reporting periods under the program. The facts applicable to example 1 of §132.1 are used in the example below to demonstrate how the net depreciation adjustment is allocated to each reporting period under the program by multiplying the \$41,000 by the ratio of depreciation determined for each period.

Allocation of Net Depreciation Adjustment to Each Reporting Period Under the Program.

<u>Cost Report Period Ending</u>	<u>Disposed Asset Depreciation Per Cost Report</u>	<u>Percent Reporting Period Depreciation to Total Depreciation</u>	<u>Allocation of Net Depreciation Adjustment</u>
6/30/69	\$ 20,000	22	\$ 9,020
6/30/70	19,000	21	8,610
6/30/71	18,000	20	8,200
6/30/72	17,000	19	7,790
6/30/73	16,000	18	7,380
Total	<u>\$ 90,000</u>	<u>100</u>	<u>\$ 41,000</u>

C. Allocation Where Provider Terminates and Is Subject to Recovery of Accelerated Depreciation.--Where a provider terminates participation in the program after July 1970; disposes of its depreciable assets and does not meet the conditions of paragraph A; and where in the case of demolished or abandoned assets, the assets are at least 80 percent depreciated, the net depreciation adjustment will be allocated to each reporting period under the program as follows:

1. The portion of the recomputed depreciation (straight-line method) that is applicable to reporting periods under the program is distributed proportionately to such periods.

2. The recomputed depreciation amount for each reporting period is compared to the actual taken in each period. The difference is the excess depreciation to be recovered.

3. The gain or loss is allocated proportionately to each reporting period under the program and is combined with the excess depreciation for that period to determine the net depreciation adjustment.

The following facts (taken from example 3, §132.1) will demonstrate how the net depreciation adjustment is allocated to each reporting period under the program.

Step 1- Recomputed depreciation \$157,500 less depreciation taken before entrance into the program \$105,000 equals \$52,500 which is divided by the five equal periods to arrive at \$10,500 for each period.

Step 2- In the schedule below, recomputed depreciation (column 3) is compared with actual depreciation taken (column 2) to arrive at excess depreciation (column 4).

Step 3- Excess depreciation (column 4) is combined with gain or loss (column 5) to arrive at net depreciation adjustment (column 6).

Allocation of Net Depreciation Adjustment to Each Reporting Period Under the Program.--

(1)	(2)	(3)	(4)	(5)	(6)
Fiscal Year Ending	Actual Depreciation Taken	Recomputed Depreciation	Excess Depreciation (2) - (3)	Gain on Sale	Net Depreciation Adjustment (4) + (5)
6/30/69	\$ 20,000	\$ 10,500	\$ 9,500	\$ 700	\$ 10,200
6/30/70	19,000	10,500	8,500	700	9,200
6/30/71	18,000	10,500	7,500	700	8,200
6/30/72	17,000	10,500	6,500	700	7,200
6/30/73	16,000	10,500	5,500	700	6,200
Total	\$ 90,000	\$ 52,500	\$ 37,500	\$ 3,500	\$ 41,000

**D. Allocation Where the Provider is Subject to Capital PPS for Some Reporting Periods Under the Program.--**After a hospital becomes subject to the capital PPS, the allocation of the net depreciation adjustment to each reporting period before and after the effective date of capital PPS must be in accordance with §2807.8.

132.4 Methods Available for Determination of Adjustment to Reimbursable Cost.--

A. Paragraph A of §132.3 describes the conditions under which a provider reflects the total net depreciation adjustment as an adjustment of depreciation in the year of disposal. Where these conditions are not met, a provider must first allocate the net depreciation adjustment to periods under the program in accordance with the provisions of paragraph B or C of §132.3. After the net depreciation for each reporting period under the program is determined:

1. The provider will compute the adjustment to reimbursable cost based upon the ratio of the program's share of reimbursable cost to total cost (see paragraph B).

2. On request of the provider, the intermediary may grant permission for the provider to compute the adjustment to reimbursable cost under the method described in paragraph C, if the provider can show that the direct costs of ancillary services furnished under arrangements in any cost reporting period, subject to recovery, are 10 percent or more of the direct costs of all ancillary services furnished.

3. Any provider may at its option compute the adjustment to reimbursable cost by recalculating, for each reporting period, all the necessary cost reporting schedules applicable to each reporting period covered by the depreciation adjustments. Schedules recomputed in accordance with this option must be submitted with the cost report for the cost reporting period in which the gain(s) or loss(es) giving rise to the depreciation adjustments took place.

The same method of computation must be used for all periods affected by the net depreciation adjustments that occur in the current reporting period.

B. Adjustment to Reimbursable Cost Based Upon the Ratio of the Program's Share of Reimbursable Cost to Total Cost.--The adjustment to reimbursable cost is computed by applying the ratio of Medicare reimbursable cost to total allowable cost for each period to the allowable portion of the net depreciation adjustment for that period. The Medicare reimbursable cost and total allowable cost includes inpatient services, nursing salary differential, outpatient and other Part B services, services provided by interns and residents not under an approved training program and ancillary services - Part B. Also, these amounts are gross allowable costs before deductibles and coinsurance billed to HI beneficiaries, return on equity capital, and the charge differential between semiprivate accommodations and less than semiprivate accommodations.

For each period under the program, that portion of the net depreciation adjustment which is applicable to nonallowable cost centers is excluded from the computation. The nonallowable portion is determined by multiplying the net depreciation adjustment for the period by the ratio of depreciation of nonallowable departments to the total depreciation claimed by the provider. See example in C below. To determine the effect on the Part B Trust Fund, the total adjustment to HI reimbursable cost for each period is multiplied by the ratio of Part B reimbursable cost to total reimbursable cost for each of the same periods. The difference between the adjustment to Part B Trust Fund will be the adjustment to Part A Trust Fund. The two examples below include no nonallowable cost centers.

Facts Applicable to Both Examples Below

Cost Report Period <u>Ending</u>	Total Allowable Cost	HI Allowable Cost	Percent HI Cost to Total Allowable Costs
6/30/69	\$640,000	\$320,000	50
6/30/70	\$630,000	\$252,000	40
6/30/71	\$600,000	\$120,000	20
6/30/72	\$580,000	\$104,000	18
6/30/73	\$570,000	\$ 85,500	15

Net Depreciation Adjustment Computed in §132.3B

Cost Report Period <u>Ending</u>	Percent HI Allowable Cost to Total Allowable Cost	Net Depreciation <u>Adjustment</u>	Adjustment to HI Reimbursable <u>Cost</u>
6/30/69	50	\$ 9,020	\$ 4,510
6/30/70	40	\$ 8,610	\$ 3,444
6/30/71	20	\$ 8,200	\$ 1,640
6/30/72	18	\$ 7,790	\$ 1,402
6/30/73	15	\$ 7,380	\$ 1,107
		<u>\$ 41,000</u>	<u>\$ 12,103*</u>

Net Depreciation Adjustments Computed in §132.3C

<u>Cost Report Period Ending</u>	<u>Percent HI Allowable Cost to Total Allowable Cost</u>	<u>Net Depreciation Adjustment</u>	<u>Adjustment to HI Reimbursable Cost</u>
6/30/69	50	\$ 10,200	\$ 5,100
6/30/70	40	\$ 9,200	\$ 3,680
6/30/71	20	\$ 8,200	\$ 1,640
6/30/72	18	\$ 7,200	\$ 1,296
6/30/73	15	\$ 6,200	\$ 930
		<u>\$ 41,000</u>	<u>\$ 12,646*</u>

\* This net adjustment is applied as a decrease to the extent of the HI reimbursable cost in the current cost reporting period and any excess not applied is treated as an overpayment to be recovered from the provider.

**NOTE:** Proprietary providers subject to recapture of accelerated depreciation can determine the effect that the net depreciation adjustment has on the computation of equity capital in accordance with the instructions contained under §§136.10ff. There is no similar prior year adjustment to equity capital for gains and losses on disposal of assets.

C. Apportionment of Net Depreciation Adjustment Based on Routine and Ancillary Utilization.--If the provider can demonstrate to the satisfaction of the intermediary that the method of recovery in B above would be inequitable, and can show that the direct costs of ancillary services furnished under arrangement are 10 percent or more of the direct costs of all ancillary services in any cost reporting period subject to the net depreciation adjustment, the intermediary may grant permission for the provider to compute the recovery under the following method.

- Step 1 - The net depreciation adjustment for each period is first allocated to outpatient services, ancillary services (by ancillary departments where the Departmental Method was used), and nonallowable cost centers, on the basis of the ratio of depreciation (direct expense to the department) claimed for each of these cost centers to the total depreciation claimed by the provider. The residual net depreciation adjustment not allocated to these centers is then allocated to each routine service cost center on the basis of the ratio of depreciation claimed for each routine cost center to total depreciation claimed for all routine cost centers.
- Step 2 - The adjustment to HI reimbursable cost for the net depreciation adjustment allocated to each cost center is determined based on the ratio of HI utilization to total utilization in the cost center, and utilizing the same basis for apportionment used in the provider's cost report, i.e., days and/or charges.

Schedule A demonstrates the process used to determine the adjustment to HI reimbursable cost based on a net depreciation adjustment in the amount of \$25,920 for the period ending 12/31/67.

132.4 (Cont.)		DEPRECIATION			05-00	
SCHEDULE A	(1)	(2)	(3)	(4)	(5)	
Period ending 12/31/67	Depr. per Cost Rpt	% of Cost Ctr Depr. to Tot Depr	Allocation of Net Depr. Adjustment (Col. 2 X line 1)	Percent HI Program Charges to Total Charges (Per Cost Report Settlement Sheet)	HI Adj. (4 X 3)	
1. Net Depr. Adj.			\$25,920			
2. Total Depr. per Cost Report \$74,139						
3. Depart. Method Ancillaries Cost-Drugs Sold Physical Therapy						
4. Comb. Method Total Ancillaries	\$ 1,335	1.8%	\$ 467	42.3%	\$ 198	
5. Nonallow. Cost Centers Beauty Shop	297	0.4%	<u>104</u>	0		
6. Net Depr. Adj. Subtotal			<u>\$ 571</u>			
			% of Routine Cost Center Depr. to Tot. Routine Depr.	Allocation of Routine Services (Col 2 x line 10 below)	% HI Utiliz. of Rout. Ser. (Per CR)	
<u>Routine Services</u>						
7. Noncert. Routine Cost Center	\$23,283	39.7%	\$10,064		0	
8. Certified Routine Cost Center	<u>35,365</u>	<u>60.3%</u>	15,285		24.7%	<u>3,775</u>
9. Tot. Routine Depr. Cert. & Uncert. <u>\$58,648</u>		<u>100.0%</u>				
10. Net Depr. Adj. App. to Routine (line 1 - line 6)			<u>\$25,349</u>			
11. HI Adjustment						\$3,973
12. Allowance (See §132.3c)						<u>79</u>
13. Net Adjustment To HI Reimbursable Cost						\$4,052

### 133. TREATMENT OF INVOLUNTARY CONVERSION LOSSES

**133.1 General.**--Losses resulting from the involuntary conversion of depreciable assets, such as condemnation, fire, theft, or other casualty, are includable in allowable costs in the year of the involuntary conversion, provided the allowable losses incurred in any cost reporting period do not exceed \$5,000 and provided the assets are replaced. If the allowable losses in any cost reporting period exceed \$5,000, the total amount of the losses is recognized as a deferred charge and treated as specified in sections 133.2 and 133.3. If after the involuntary conversion, the depreciable asset is no longer used in providing patient care or is not replaced, no amount of the loss is includable in allowable costs. However, if the provider intends to replace or restore the asset but is unable to do so because the designated State Health Planning and Development Agency finds such replacement or restoration to be inconsistent with the health system's plan of the provider's health service area, the loss is allowable so long as the provider continues to participate in Medicare. In this case, the loss is capitalized as a deferred charge and amortized over the remaining life of the involuntarily-converted asset, or at the rate of \$5,000 per year, whichever is greater.

Losses resulting from a provider's imprudent management of its depreciable assets, such as failure to obtain proper insurance coverage, are not includable in allowable costs. (See section 2160.5E.)

If a gain is realized from the involuntary conversion of a depreciable asset, the net amount realized shall reduce the basis of the restored or replaced asset. If the asset is not restored or replaced, the gain is treated as part of the net depreciation adjustment in accordance with section 132.3.

If a replaced or restored asset resulting from an involuntary conversion ceases to be used in the provision of patient care services or the provider terminates its participation in the Medicare program, the unamortized deferred charge remaining at that time shall not be included in determining allowable cost under the Medicare program. However, if the asset is transferred to an organization considered related as defined in section 1002.1 and the purchasing organization continues as a provider in the Medicare program, the remaining deferred charge representing the unrecovered basis of the involuntarily converted asset shall continue to be amortized over the number of years considered as the remaining estimated useful life of the replacement or restored asset. Where the asset is transferred to an unrelated provider, further amortization of the deferred charge is not allowed.

**133.2 Total Casualty Losses.**--If a depreciable asset is destroyed by an involuntary conversion beyond repair and the amount of the allowable loss exceeds \$5,000, the loss must be capitalized as a deferred charge over the estimated useful life of the asset which replaces it. The allowable loss for a total casualty is the undepreciated cost or unrecovered book value of the asset, less insurance proceeds,

gifts, and grants received from local, State, or Federal Government, or any other source as a result of the involuntary conversion. If the unrepairable asset is disposed of by scrapping, income received from salvage is treated as a reduction in the amount of the allowable loss. Conversely, where additional expense is incurred in the scrapping operation, such cost would be added to the allowable loss of the destroyed asset.

**133.3 Partial Casualty Losses.**--If a depreciable asset is partially destroyed or damaged as a result of an involuntary conversion, a reduction in its cost basis (the book value) is assumed to have taken place. Therefore, the cost basis of the asset must be reduced to reflect the amount of the casualty loss, regardless of whether the loss is covered by insurance.

The amount of the casualty loss is the difference between the fair market value immediately before the casualty and the fair market value immediately after the casualty; **however, for program purposes the allowable loss is limited to the percent of loss in fair market value applied to the net book value of the asset at the time the casualty occurred.** This method of calculating the allowable loss recognizes the actual reduction in the cost value of the asset rather than the reduction in replacement value. If the allowable loss in any cost reporting period exceeds \$5,000, the loss must be capitalized as a deferred charge and amortized over the useful life of the restored asset.

The fair market value generally can be ascertained by competent appraisal. If no appraisal is made, the cost of repairs to the damaged property is acceptable as evidence of the loss of value if the repairs restore the property to its condition immediately before the casualty and, as a result of the repairs, the value of the property has not been increased. The amount of the allowable loss is then deducted from the cost basis of the asset before the casualty, to arrive at the adjusted cost basis of the asset. Any insurance proceeds received or recoverable must be deducted from the amount of the casualty loss to determine the gain or the loss.

EXAMPLE:

Fair market value - before	\$16,000
Fair market value - after	4,000
Casualty loss	<u>\$12,000</u>

Percentage of loss in fair market value ( $\$12,000 \div \$16,000 = 75\%$ )

Amount of loss to be recognized by the program:

Net book value of the asset at the time of the casualty	\$12,000
Amount of partial casualty loss to be allowed (75% x \$12,000)	9,000
Adjusted cost basis of asset	<u>\$ 3,000</u>

The allowable portion of the partial casualty loss (\$9,000) is recognized as a deferred charge and amortized over the estimated useful life of the restored asset.

Actual costs incurred in the restoration of an asset, including expenditures from the self-insurance reserve fund, are added to the adjusted cost basis of the asset to arrive at the revised cost of the restored asset and capitalized over what is determined to be the remaining useful life of the restored asset. When the repairs materially improve or add to the value or utility of the property or appreciably prolong its useful life, a redetermination of the expected useful life will be necessary.

The following chart shows the method of adjusting the cost basis and of determining the amount of the gain or loss.

PARTIAL CASUALTY LOSSESEXAMPLES: ADJUSTMENT OF COST BASIS; DETERMINATION OF GAIN OR LOSS

A	B	C	D
<u>Net Book Value Before Casualty</u>	<u>before Casualty</u>	<u>Value after Casualty</u>	<u>Ratio of Loss to Value Fair Market Value before Casualty</u>
1. \$10,000	\$16,000	\$ 8,000	50%
2. 10,000	10,000	2,000	80%
3. 5,000	20,000	16,000	20%
4. 10,000	18,000	1,800	90%
E	F	G	H
<u>Amount of Casualty Loss (D x A)</u>	<u>Adjusted Cost Basis (A - E)</u>	<u>Insurance Received or Recoverable</u>	<u>Gain or Loss</u>
1. \$5,000	\$5,000	\$ 3,000	\$2,000(Loss*)
2. 8,000	2,000	8,000	-0-
3. 1,000	4,000	4,000	3,000(Gain**)
4. 9,000	1,000	10,000	1,000(Gain**)

| **\*Not allowable.** This example assumes provider does not have adequate insurance to cover this loss. (This example does not include a deductible.)

| **\*\*Gains are treated in accordance with the instructions contained in the third paragraph of § 133.1.**

133.4 Losses for Application of Customary Deductible Clause.--A loss which is determined to be an allowable cost, e.g., loss due to the application of the customary deductible clause (subject to the limitation expressed in § 133.1), is recognized as a deferred charge (after application of insurance proceeds), and **amortized over the remaining useful life of the asset or its replacement if the loss exceeds \$5,000.**

EXAMPLE: A hospital building sustained severe damage from an earthquake in an area in which a prudent businessman would be expected to purchase earthquake insurance. The provider's insurance policy carried a 5 percent deductible clause (5 percent of the insured value which is not reimbursed by the insurance company) and the amount of the proceeds from the insurance company totaled \$550,000. Other information is as follows:

Insured and fair market value of hospital immediately before casualty	\$11,000,000
Fair market value of hospital immediately after casualty	<u>9,900,000</u>
Amount of casualty loss	\$ 1,100,000
Deductible	5%
Net book value of hospital at time of casualty	\$ 9,000,000

Computation of allowable loss:

Ratio of amount of casualty loss to fair market value immediately before casualty:

$$\frac{\$ 1,100,000}{\$11,000,000} = 10\%$$

Net book value at time of casualty	x ratio =	adjusted loss
\$ 9,000,000	x 10% =	\$ 900,000

Adjusted cost basis:

Net book value at time of casualty	\$ 9,000,000
Adjusted loss	<u>900,000</u>
Adjusted cost basis for program purposes	<u>\$ 8,100,000</u>

If and when the property is repaired, the restoration costs would be added to the adjusted cost basis.

Adjusted cost basis	\$8,100,000
Plus: Restoration costs, including improvements	<u>1,000,000</u>
Revised cost basis	<u>\$9,100,000</u>

Allowable casualty loss:

Amount received from insurance-	
Casualty loss	\$1,100,000
Less: deductible 5% x \$11,000,000	
<u>550,000</u>	
Net amount received from insurance	<u>\$ 550,000</u>

Adjusted loss	\$ 900,000
Net amount received from insurance	<u>550,000</u>
Allowable loss (adjusted deductible)	<u>\$ 350,000</u>

The allowable loss of \$350,000 is entered on the books of the provider as a deferred charge and amortized over the expected useful life of the restored asset. Where the provider terminates participation in the program, the unamortized portion of the allowable loss is not included in allowable costs.

133.5 Limitation on Allowable Cost Where Provider Maintains a Self-Insurance Reserve Fund.-- Where the provider maintains a self-insurance reserve fund, the amount of the casualty loss recognized as an allowable cost is limited to the lesser of the **decrease in fair market value, as adjusted**, of the damaged or destroyed asset (§§133.2 and 133.3) or the amount of cash, investments, etc., comprising the accumulated balance in the self-insurance reserve account.

EXAMPLE:

Amount accumulated in the self-insurance reserve fund	\$20,000
Amount accumulated in the self-insurance reserve fund	
<u>\$20,000</u>	
Cost of Asset	\$100,000
Less: Depreciation Allowed	<u>60,000</u>
Unrecovered book value	\$40,000
Less: Amount of Casualty Loss (as adjusted - §133.2)	<u>25,000</u>
Adjusted cost basis of asset	<u>\$ 15,000</u>

As the allowable loss is limited to the lesser of the amount of the casualty loss, as adjusted, or the total amount in the self-insurance reserve fund, the allowable loss is limited to \$20,000. This amount is entered on the books of the provider as a deferred charge and amortized over the estimated useful life of the restored or replacement asset. The balance of the loss, \$5,000, is not recognized as an allowable cost because the provider failed to maintain an adequate reserve in the self-insurance reserve fund.

## 134. APPRAISAL GUIDELINES

Where historical cost records of a purchased asset are not available or are incomplete, or where fair market value or current reproduction cost must be established for purposes of §§104.10, 104.14, or 104.16, a timely appraisal of the historical cost, fair market value or depreciated reproduction cost (as appropriate) of the asset made by an independent, recognized expert will be acceptable for depreciation and owner's equity capital purposes. The appraisal of the historical cost of assets should produce a value approximating the cost of reproducing substantially identical assets of like type, quality, and quantity at a price level in a bona fide market as of the date of acquisition. The appraisal expert may also assist the provider in the development of permanent fixed asset records. The appraisal must be conducted in accordance with "The Principles of Appraisal Practice and Code of Ethics" of the American Society of Appraisers.

134.1 Approval of an Appraisal.--Before an appraisal is made for Medicare purposes, the provider will inform its intermediary of its intent, and the reason for the appraisal. The provider will also make the proposed appraisal agreement available to its intermediary. The proposed agreement should specify such information as the appraisal date, estimated date of completion, scope of the appraisal, and a statement that in the judgment of the appraisal firm the results will conform to the then current Medicare regulations on principles of reimbursement for provider costs. The intermediary will promptly determine if the firm qualifies as an independent expert, and whether the proposed appraisal meets program requirements regarding type, technique, and results.

134.2 Need of Appraisal for Program Purposes.--An appraisal for program purposes should be made only where the provider has no historical cost records or has incomplete records of the depreciable fixed assets or needs to determine an asset(s)' fair market value or depreciated reproduction cost. The appraisal should develop the historical cost and related information that will assist in the construction, reconstruction, or revision of accounting records to enable the provider to make proper distribution of depreciation expense in Medicare cost reports. Normally, a proprietary provider will not need a historical cost appraisal since its Federal tax return and supporting records will show the historical cost basis of its assets. Where an appraisal is being performed to determine the current reproduction cost of an asset, the appraisal should represent the cost to reproduce the actual facility in like kind, and should not be inflated by such factors as current or anticipated space needs or different construction types (e.g., masonry vs. wood frame).

Appraisals must be performed within the time limits specified in the proposed agreement and not on a piece-meal or intermittent basis.

134.3 Asset Values of Proprietary Providers Determined by Appraisals.--Where a historical cost appraisal of a proprietary provider's assets is necessary because its property or Federal tax records do not adequately reflect the cost of the facility for Medicare purposes, the intermediary will recognize the appraised cost for Medicare reimbursement purposes but not to exceed the cost basis of these assets used for Federal tax purposes. There may be assets originally charged off as expense under a provider's capitalization policy that are still in use or assets fully depreciated for Federal income

tax purposes but still in use. Medicare will recognize for depreciation purposes an appropriate adjustment to the income tax valuation in the case of such assets where the correctness of the adjustment can be documented. The allowed valuation would be the cost of such assets as of the dates of acquisition less depreciation based on the expired portion of their useful lives as they may be revised for Medicare purposes.

Where minor equipment (§104.5) is concerned, the Medicare program recognizes that the inventory costs of such equipment may not truly reflect the cost of equipment purchased and in use by the provider. Differences in the capitalization policies of providers and their desire to limit property record controls over certain classes of small assets cause variations in the recorded costs of assets generally considered depreciable. Medicare then will recognize an appropriate adjustment to the inventory costs of these assets used by the provider for income tax purposes to acknowledge the additional assets included and will permit the depreciation or amortization of the remaining cost over the remaining useful lives of the assets.

However, where all other depreciable assets are concerned, such as buildings, building equipment, major movable equipment, land improvements, and leasehold improvements, Medicare will not recognize a historical cost of such assets in excess of the historical cost used for Federal income tax purposes. Providers should be able to support this historical cost by reference to original documents such as contracts, vouchers, checks, and other evidence. If the provider does not have such original documentation constituting primary evidence of the historical cost of assets, the intermediary will consider the provider's Federal income tax returns as secondary evidence to be used in establishing or verifying the historical cost of the assets. Further, it is possible that because of the effects of other provisions of the regulations, such as "Cost to Related Organizations," the historical cost under Medicare might be less than that allowed and used for Federal income tax purposes.

Under the regulations, providers may change the useful lives of assets where this can be justified and appropriately adjust the accumulated depreciation applicable to the historical cost of the assets involved. The effect of such adjustments is to change the undepreciated amount of the historical cost for Medicare purposes. The regulations do not permit providers to increase the historical cost basis of their assets to recognize elements of costs or expenditures which were not capitalized but were considered as expense items. For example, if a provider determined that a physical modification of the building was a repair and thus an item of expense not capitalized and uses the historical cost so determined for Federal income tax purposes, the provider may not change the historical cost basis to include that expenditure previously determined a repair and capitalize it; i.e., increase the historical cost basis of the building for Medicare purposes. As another example, if a provider builds a facility and in establishing the historical cost of the building determines that materials and labor used were not part of the historical cost of the building and charges the cost of such materials and labor into expenses for Federal income tax purposes, the provider may not then include such expenditures in the historical cost of the building for Medicare purposes.

These guidelines are to be applied retroactively as well as prospectively. Where an intermediary has approved an appraisal resulting in the establishment of asset costs in excess of the cost basis used for Federal income tax purposes, or where a proprietary provider has increased the historical cost basis of its assets to an amount in excess of the historical cost basis used for Federal income tax purposes by reference to supporting documentation, the intermediary will require a redetermination of historical costs. Costs in excess of the cost basis used for Federal income tax purposes will not be recognized under Medicare. Further, for cost reporting periods beginning on or after January 1, 1970, the intermediary will also require a redetermination of allowable costs for the reporting period covered to reflect the effects of the adjustment in the historical cost basis of the assets. For cost reporting periods beginning before January 1, 1970, however, no redetermination of such allowable costs need be made for the reporting periods covered. Accumulated depreciation applicable to the depreciable assets under the program will include the full amount allowed during those periods in which an increased historical cost basis was used. The net book value so established shall be used for computations of equity capital and determinations of gain or loss on the sale of assets and for any other reimbursement purposes under Medicare.

134.4 Fixed Assets Included in Appraised Values.--Fixed asset values established by an appraisal must include all provider-owned plant assets used in patient care or in the overall operation and administration of the institution. Fixed assets used in research and other nonallowable cost areas or functions should be included so that depreciation is reflected in those departmental costs to provide a proper basis for allocating administrative and general expense. Fixed assets of a related organization not used by a provider in rendering patient care, assets acquired in anticipation of expansion, and assets held for investment and not used in the plant operation should not be included as a part of the appraised values.

Generally accepted accounting principles relating to improvements or betterments must be followed in determining the asset valuation established by the appraisal. Repair or maintenance of a nature that restores an asset to its original condition but does not extend its useful life is not a betterment or improvement but an expense of that period.

134.5 Pricing Sources.--

A. Prime or Basic Source.--The pricing of assets to establish historical costs will be based on such actual supporting documents as vendor invoices and construction contractor completion statements. In the absence of invoices such other records as revenue stamps, board minutes, contracts of purchase and deeds recorded with the county's Recorder of Deeds may be used.

B. Other Sources and Techniques.--Other methods, such as manufacturer's catalogs, libraries of material prices, or techniques involving reverse trending and price indexes may be used to establish acquisition costs and acquisition dates. Such methods may be used only when actual supporting documents are not available. When these sources and techniques are used, consideration must be given to manufacturer's and quantity discounts. The values arrived at should closely approximate the actual historical cost of an asset at the date of acquisition.

The use of these sources and techniques must be disclosed, including the general nature of the method(s), in the appraisal report or results.

134.6 Donated Assets.--Where the provider's records do not contain the fair market value of donated assets as of the date of donation, an appraisal of such fair market value on the date of donation by the appraisal expert will be acceptable for depreciation and owner's equity capital purposes.

Where material, labor, and services are donated in the construction of an asset, the asset value is the sum of the appraised cost of the material, labor, or services actually donated and the incurred cost of that part which was not donated. Labor costs should be determined in accordance with the rates prevailing in the community (at the time of construction) and the type of labor incurred. For example, if the labor donated was nonunion labor, the cost would be at the nonunion labor rate as opposed to a union labor rate. If records are not available as to the actual labor, services or material donated, the fair market value at the time of donation may be determined by the other methods shown in §134.5. Estimated labor costs provided by an owner or shareholder of an institution are not includable in the historical cost of constructed assets.

134.7 Treatment of Assets Costing Less Than \$100.--Individual major movable assets costing less than \$100 (whether or not purchased in quantity prior to the appraisal date) may be capitalized at the time of appraisal at the purchase cost less accumulated depreciation from the date of acquisition regardless of the provider's past accounting practices. If an election is made to capitalize such assets, this policy must be applied consistently.

Providers which have expensed such items while in the program may not decide later to capitalize them. This also applies to those providers which eventually decide to have appraisals. Major movable equipment with a unit cost of \$100 or less may be grouped by the appraisal expert. However, the book value assigned to such grouped assets at appraisal may not exceed the book value of the assets if individually appraised. Identification of the individual assets comprising the group must be available.

134.8 Tagging of Major Equipment.--For program purposes, tagging of equipment is not mandatory. In the absence of tagging, however, alternate records must exist to satisfy audit verification of the existence and location of assets.

134.9 Appraisal Programs.--Since the condition of provider asset records varies significantly, an appraisal program may be comprehensive or partial. For instance, a provider may engage an appraisal firm to appraise a part of its facility for which no historical records have been maintained, or a provider may need to have an appraisal made on a particular class of assets in a specific identified location.

Comprehensive type programs are usually appropriate because of such complexities as lump-sum purchases of assets or a complete lack of historical cost records for all assets.

An appraisal program should include:

1. A physical inventory and listing of pertinent data for all applicable assets in use, or in standby status, at the appraisal date or report date. The physical inventory may be made by the provider or the appraiser. If made by the provider such inventory must be verified by the appraiser.

2. The acquisition cost of each item or unit of property, including architect fees, installation costs, freight, etc.

3. A classification of each item or unit of property in accordance with the [AHA Chart of Accounts for Hospitals](#). These classifications are:

- a. Land improvements
- b. Buildings
- c. Fixed equipment
  - (1) Building services equipment
  - (2) Other fixed equipment
- d. Major movable equipment
- e. Minor equipment
- f. Leasehold improvements

4. Establishing an estimated useful life for each asset. (See § 104.17.) The estimated useful life established for each asset for purposes of the appraisal must be consistent with the estimated useful life for each asset used by the provider for depreciation purposes.

5. Determining a salvage value for each asset. (See § 104.19.)

6. Selecting a depreciation method for each asset.

7. Calculating depreciation provisions for the current reporting period.

8. Calculating accumulated depreciation using an approved basis from the date of acquisition to the start of the first reporting period under Medicare in which actual depreciation is first claimed.

9. Determining square footage for each cost center to identify all rooms on a floor or within a building if this was not previously done by the provider. This should be accomplished as explained in the [AHA Cost Finding and Rate Setting for Hospitals](#).

10. Reconciling appraisal results with provider records. For assets acquired prior to January 1, 1966, the provider's plant asset records, if any, and accounting records must be considered even though they may be inaccurate. This reconciliation must be made from land improvements, buildings, building services equipment, and where possible for other major asset classifications.

Where applicable, difference disclosed by the reconciliation must be reflected as adjustments in the provider's accounting and plant assets records.

#### 134.10 Appraisal Report.--

A. Certification and Transmittal.--A letter of certification and transmittal should accompany the appraisal results. The certification should state that in the judgment of the appraisal firm the results were determined in conformity with Medicare regulations and requirements. This letter will include such information as:

1. Name of provider.
2. Location(s) of facilities included in appraisal.
3. Appraised date, date up to which accumulated depreciation was calculated (of other than appraisal date) and period for which current depreciation is calculated.
4. Contents of data supplied to provider--summaries, schedules, plans, etc.
5. Appraisal program description--extent of asset appraisal, i.e., physically inventoried, etc., pricing bases, and other pertinent information not readily apparent in the detail results (e.g., depreciation methods).
6. Policy for determining capitalizable assets.
7. Depreciation policy in the year of acquisition and disposal.
8. Identification of material items included in the appraisal where the values of such items were obtained from outside sources without independent verification by the appraisal firm.

B. Listings of Assets Appraised.--If a listing of assets which constitutes the provider's Medicare property records is supplied, it must contain all necessary and pertinent information, even if portions were determined solely by the provider.

1. A listing of assets should include the following data for each asset;

number, etc.)

- a. Building location
- b. Cost center or department
- c. Asset description (usually includes manufacturer's name, model, number, serial number, etc.)
- d. AHA asset classification
- e. Historical cost
- f. Acquisition date
- g. Estimated useful life to provider
- h. Salvage value
- i. Depreciation provisions for current reporting period
- j. Accumulated depreciation provision at appraisal or other pertinent date(s)
- k. Pricing method where necessary for adequate disclosure, where more than one method used on various assets

2. Reconciliations and comparisons with provider records must be included.

3. Square footage and other allocation basis information for buildings and cost centers within buildings must also be included.

The intermediary will make the final decision as to the acceptance of the appraisal results for Medicare purposes.

134.11 Appraisal Records.--The appraisal firm's work papers and supporting documents must be available to the intermediary or its audit capability for examination upon reasonable request.

134.12 Appraisal Expense.--Appraisal expense, including that expense for appraisal of research and other nonpatient departments, incurred by a provider after entrance into the program to establish plant records for Medicare purposes may be included in allowable cost only if the appraisal had been approved by the intermediary. Such expenses will be considered as allowable administrative costs in the period incurred, subject to apportionment to the Medicare program. Appraisal expense incurred in appraisal of assets not connected with provider operations may not be included in allowable costs.

Where providers have appraisals made for other business purposes (insurance coverage, tax values, and financing), the expenses incurred for such appraisals may be included in allowable costs as part of general and administrative costs. However, appraisal expense incurred to establish values for the sale or anticipated sale of a provider organization are not includable in allowable costs. Where the intermediary determines that a provider has incurred appraisal expense to establish the historical cost of assets which were already adequately reflected in its books, records or tax return, the cost of performing the appraisal is not allowable.

### 136. RECOVERY OF ACCELERATED DEPRECIATION UPON TERMINATION OR DECREASE IN PROGRAM'S SHARE OF ALLOWBLE COST

When a provider that has used an accelerated method of depreciation with respect to any of its assets terminates participation in the program after July 1970, or where the health insurance proportion of its allowable costs for periods starting after July 1970 decreases so that cumulatively substantially more depreciation was paid than would have been paid using the straight-line method of depreciation, the excess or reimbursable cost, determined by using accelerated depreciation methods and paid under the program over the reimbursable cost which would have been determined and paid under the program by using the straight-line method of depreciation, will be recovered as an offset to current reimbursement due or, if the provider has terminated participation in the program, as an overpayment.

The optional allowance for depreciation (based on a percentage of operating costs -- see §124) is not considered an accelerated method of depreciation.

**136.2 Recovery of Excess Depreciation Upon Termination.**--The recovery of amounts paid in excess of straight-line depreciation is applicable to voluntary and involuntary terminations, and to providers that change ownership. The adjustment for amounts paid in excess of straight-line depreciation does not apply to terminations effective prior to August 1970. (See §136.5 for exception)

When a provider ceases to participate in the program after July 1970, the adjustment to a straight-line depreciation basis applies to all cost reporting periods in which accelerated depreciation was claimed under the program. However, an adjustment for amounts paid in excess of straight-line depreciation is not made where the cumulative total of HI days for all reporting periods in which the provider claimed accelerated depreciation is less than 5 percent of the cumulative total of inpatient days in the facility (certified area only) for the same reporting periods.

### 136.3 Termination and Disposal of Assets.--

A. **General.**--Where a provider ceases to participate in the program after July 1970 and disposes of assets during its final cost reporting period, or within 1 year after termination, the methodology contained in §§132ff. will be followed to determine the adjustment to reimbursable cost.

If a recovery of amounts paid in excess of straight-line depreciation is made under §136 and the former provider subsequently disposes of its assets subject to the provisions of §132, the adjusted book value resulting from the recovery of accelerated depreciation is the basis for the calculation of the gain or loss.

B. **Gain or Loss on Disposition of Asset.**--Where an asset had previously been disposed of and depreciation for the asset was adjusted

under the provision of §132 (Gains and Losses on Disposal of Depreciable Assets), any accelerated depreciation claimed on that asset is excluded from the computation of excess depreciation for purposes of this section.

136.4 Decrease in Health Insurance Proportion of Allowable Costs.--

A. General.--If the provider has experienced a decrease in its health insurance proportion of allowable costs, as defined in B, C, and D, below, a recovery of amounts paid in excess of straight-line depreciation is made. The recovery is made for all cost reporting periods in which accelerated depreciation was claimed under the program, except the computation period. The computation of the amount to be recovered is shown in §136.6.

B. Amount of Decrease.--A recovery of amounts paid in excess of straight-line depreciation is made where the provider's ratio of health insurance days to total inpatient days (certified areas only) has decreased 25 percent or more in the overall average of HI days in the base period and the HI days in the computation period. In addition, a recovery of amounts paid in excess of straight-line depreciation due to a decrease in HI utilization is not made where the cumulative total of HI days in the base period is less than 5 percent of the cumulative total of inpatient days in the facility (certified areas only).

EXAMPLE:

Comparison of Ration of HI Utilization in Computation Period to HI Utilization in Base Period.--  
(Provider entered program 1/1/67.)

<u>FYE</u>	<u>Total Inpatient Days</u>	<u>Total HI Days</u>
12/31/71	72,000	17,280
12/31/72	72,727	16,000
12/31/73	80,000	8,000

1. First Computation Period.--FYE 12/31/72.

Base period ratio - percent of HI days to total inpatient days (FYE 12/31/71)	24%
Computation period ratio - current year's percent of HI days to total inpatient days (FYE 12/31/72)	22%
Decline in HI ratio - (Base period ratio less computation period ratio)	2%

Percentage of Decline in HI Participation

$$\frac{\text{Decline in HI ratio}}{\text{Base period ratio}} = \frac{2}{24} = 8\%$$

As the ratio of HI utilization in the computation period has not decreased 25% or more from the HI utilization in the base period, no adjustment is necessary.

2. Second Computation Period.--FYE 12/31/73.

Base period ratio - percent of HI days to inpatient days (FYE 12/31/71 ÷ FYE 12/31/72) 23%

Computation period ratio - current year's percent of HI days to total inpatient days (FYE 12/31/73) 10%

Decline in HI ratio - Base period ratio less computation period ratio) 13%

Percentage of Decline in HI Participation

$$\frac{\text{Decline in HI ratio}}{\text{Base period ratio}} = \frac{13}{23} = 56\%$$

As the ratio of HI utilization in the computation period has decreased more than 25% from the HI utilization in the base period, a computation to determine if there has also been a decrease of 25% or more in the number of HI days must be made.

Base period - average number of HI days (17,280 + 16,000 ÷ 2) 16,640

Computation period - actual number of HI day 8,000

Decrease in number of HI days 8,640

Percentage of decrease in number of HI days:

$$\frac{8640}{16640} = 52\%$$

As there has been a decrease of 25% or more in both the number of HI days, and HI utilization, and adjustment to recover amounts paid in excess of straight-line depreciation must be made.

C. Computation Period.--The computation period is defined as the provider's current cost reporting period starting after July 1971.

D. Base Periods.--

1. Initial Base Period.--The initial base period for the recovery of amounts paid in excess of straight-line depreciation includes one or more cost reporting periods beginning with the provider's first cost reporting period starting after July 1970, and including all cost periods thereafter, except the computation period.

2. Subsequent Base Periods.--The base period after a recovery of amounts paid in excess of straight-line depreciation, begins with the first cost period after the end of the prior base period and all cost periods thereafter, except the current computation period.

EXAMPLE:

Computation Period and Base Period

(1) <u>Initial Recovery.</u> --				
Reporting Period Ending	First Computation Period	Base Period*	Second Computation Period	Base Period
3/31	4/1/72-3/31/73	4/1/71-3/1/72	4/1/73-3/31/74	4/1/71-3/31
6/30	7/1/72-6/30/73	7/1/71-6/30/72	7/1/73-6/30/74	7/1/71-6/30
9/30	10/1/71-9/30/72	10/1/70-9/30/71	10/1/72-9/30/73	10/1/70-9/30/72
12/31	1/1/72-12/31/72	1/1/71-12/31/71	1/1/73-12/31/73	1/1/71-12/31/72

(2) Subsequent Recovery.--If a recovery of accelerated depreciation is made based on a decrease in utilization in a computation period, this computation period becomes the first period in the subsequent base period. For example, if a decrease in HI utilization in the second computation period (1/1/73-12/31/73) results in a recovery, the base period for any subsequent recovery will commence with the period 1/1/73-12/31/73.

\* Example assumes base period included 12-month reporting periods.

E. Short Cost Reporting Periods.--A recovery of amounts paid in excess of straight-line depreciation is not instituted on the basis of a computation period covering less than 6 months of health insurance participation. This may occur, for example, where a provider has received permission to change its cost reporting period and the transitional report is less than 6 months of health insurance participation. However, this does not exclude applying the adjustment to a short period report when a recovery is subsequently required.

136.5 Termination Due to a Change in Provider Ownership Resulting From a Transaction Between Related Parties.--The recovery of accelerated depreciation will not be made when all four of the following conditions are met:

- A. The termination of the provider agreement is due to a change in ownership of a provider resulting from a transaction between related parties,
- B. The successor organization participates in the program,
- C. Control and the extent of the financial interest of the owners of the provider before and after the termination remain the same, and
- D. All assets and liabilities of the terminated provider are transferred to the related successor provider.

Where all four of these conditions are not met, the recovery of accelerated depreciation as required by §136.2 will be implemented.

Examples of transactions that result in a termination of one provider agreement and the establishment of another, but which do not require a recovery of accelerated depreciation include, but are not limited to, a merger of a wholly-owned subsidiary corporate provider into the parent corporation or into another wholly-owned subsidiary corporation of the parent corporation; a consolidation of two or more corporate providers forming a new corporate provider; the incorporation of a sole proprietor or partnership with stock ownership in the same ratio as the prior proprietary interest; the transfer of a provider operated as a branch of the parent corporation to a wholly-owned subsidiary; or a change in organization structure from a solely-owned corporation to a sole proprietorship. In such cases, the recovery of accelerated depreciation provision of §136.2 is not applied, but rather the transaction is treated as follows:

- a. the net book value of the assets, the liabilities related to the assets and the method of depreciation as recorded on the books of the terminated provider shall be used by the successor provider;
- b. the successor provider must record the historical cost and accumulated depreciation of the terminated provider recognized under the program and these are considered as incurred by the successor provider for program purposes, such as gain or loss on any subsequent disposition of assets or recovery of accelerated depreciation;
- c. the HI utilization of the terminated provider is considered as incurred by the successor provider for purposes of §136.4; and

d. the equity capital of the successor provider as of the beginning of the first cost reporting period must be the same as the equity capital of the terminated provider as of the closing of the final cost report.

To assure that the intermediary is cognizant of all pertinent facts, and officer of the successor provider must furnish a statement to the intermediary concerning the transaction in relation to these four elements at the time the new provider agreement is entered into. If such statement is not furnished to the satisfaction of the intermediary, §136.2 will apply.

136.6 Methods of Determining Amounts to be Recovered by HI Program for Depreciation Paid in Excess of Straight-Line Depreciation.--

A. General.--For each affected cost period excess depreciation to be recovered is the amount of depreciation reimbursed under an accelerated method less reimbursable depreciation computed under the straight-line method. After the excess depreciation for each cost period is determined;:

1. The provider will compute the amount to be recovered based upon the ratio of the program's share of reimbursable cost to total allowable cost (see B1 below);

2. On request of the provider, the intermediary may grant permission for the provider to compute the recover under the method described in B2 below, if the provider can show that the direct costs of ancillary services furnished under arrangements in any cost reporting period subject to recovery are 10 percent or more of the direct cost of all ancillary services furnished; or

3. Any provider subject to recovery may, at its option, compute the recover by recalculating the necessary cost reporting schedules.

The same method of computation must be used for all periods in which a recovery is being made.

B. Methods.

1. Apportionment of Excess Depreciation Based Upon Ratio of HI Reimbursable Cost to Total Allowable Cost.--The program's share of excess depreciation is computed by applying the ratio of Medicare reimbursable cost to total allowable cost to the excess depreciation for each period. (See example page 28)

2. Apportionment of Excess Depreciation Based on Routine and Ancillary Utilization.-

Step 1 - The total depreciation claimed in excess of straight-line depreciation for each period (accelerated depreciation claimed less depreciation computed under the straight-line method) is first allocated to outpatient services, ancillary services (by ancillary department where the Departmental Method was used) and nonallowable cost centers on the basis of the ratio of depreciation (direct expense to the department) claimed for each of these cost centers to the total depreciation claimed by the provider. Any residual excess depreciation not allocated to these centers is then allocated to the routine service cost center(s). This excess depreciation is apportioned to each routine cost center on the basis of the ratio of depreciation claimed for each routine cost center to total depreciation claimed for all routine cost centers.

NOTE: This space reserved for apportionment of excess depreciation based upon ratio of reimbursable cost to total allowable cost.

Step 2 - The program's share of the excess depreciation allocated to each cost center is recovered based on the ratio of HI utilization to total utilization in the cost center, and utilizing the same basis for apportionment used in the provider's cost report--i.e., (days and/or charges).

Note: This space reserved for apportionment of excess depreciation based on routine and ancillary utilization.

136.7 Allowance in Lieu of Specific Recognition of Other Costs and Return on equity Capital.--The recovery of the amount paid in excess of straight-line depreciation has an effect on the allowance in lieu of specific recognition of other costs--reimbursable for services provided through June 30, 1969 (see §136.10), and the return on equity capital (see §136.11).

136.8 Basis of Assets Following Recovery of Amounts Paid in Excess of Straight-Line Depreciation.--A recovery of the amount paid in excess of straight-line depreciation due to a decrease in health insurance utilization results in an increase in the book value of those assets for which accelerated depreciation had been claimed. This increase in book value is equal to the depreciation claimed by the provider in excess of straight-line depreciation. The depreciable basis of these assets, therefore, is increased beginning with the reporting period following the recovery period, to the extent of the depreciation recovered in excess of straight-line depreciation allowed to the provider.

After a recovery of depreciation in excess of straight-line depreciation, a provider may continue to use the same method of accelerated depreciation. Allowable depreciation after the recover period is based upon the adjusted book value of the asset and is allocated over the remaining life of the asset.

136.10 Effect of Recovery of Amounts Paid in excess of Straight-Line Depreciation on the Allowance in Lieu of Specific Recognition of Other Costs.--For each cost reporting period where depreciation paid in excess of straight-line depreciation has been recovered under §§136ff., the provider's allowable cost for each of those periods is decreased by that amount. Therefore, the provider's allowance in lieu of specific recognition of other costs (applicable to services provided through June 30, 1969) is adjusted.

The amount recovered as a result of this adjustment is computed by applying the appropriate rate for the allowance in lieu of specific recognition of other costs (12 percent for proprietary providers or 2 percent for non-profit providers) to the HI adjustment for recovery of excess depreciation.

For cost reporting periods beginning before July 1, 1969, and ending after June 30, 1969, the full allowance should be calculated and the sum so obtained shall be apportioned to that part of the period before July 1, 1969, by applying to that sum a fraction consisting of a numerator which is the number of months before July 1969 and a denominator which is the number of months in the cost reporting period. Thus, if a provider's 12-month reporting year ended December 31, 1969, the allowance recovered would be  $6/12 \times$  the allowance that would have been paid for the full 12-month period.

136.11 Computation of Increase in Equity Capital.--For proprietary institutions, the adjustment of accelerated depreciation to straight-line depreciation for a cost reporting period results in an increase in the provider's equity capital for each period in which accelerated depreciation is adjusted to straight-line depreciation is equal to the increase in the book value of the asset(s) as a result of the adjustment, less the additional reimbursement received by the provider as a result of claiming accelerated depreciation and the allowance in lieu of specific recognition of other costs. Also, the payments of the return on equity capital resulting from the conversion of accelerated depreciation to straight-line, increase the equity capital for subsequent cost reporting periods. (See example in §136.15A.)

136.13 Computation of Average Equity Capital Due to Adjustment From Accelerated Depreciation to Straight-Line Depreciation.--Section 136.11 explains the computation of the increase in equity capital due to the adjustment of accelerated depreciation to straight-line depreciation. Reimbursement to providers for the allowance of a reasonable return on equity capital, however, is based on the average equity capital during each reporting period. This section illustrates the computation of the estimated average equity capital as a result of the adjustment to straight-line depreciation.

The average equity capital for the earliest period for which recovery is made is one-half of the increase in equity capital for the period under the provisions of §136.11. The average equity capital for each period following the earliest period is one-half of the increase in equity capital for each prior period. This computation of average equity capital is illustrated in §136.15A.

For a reporting period during which the provider had previously had a zero equity balance at the end of an month, the average equity capital adjustment for the period is decreased by the percentage that the number of months in the period showing a zero balance bears to the total months in the period. (See illustration in §136.15B.)

(As an alternative to the procedures described in this section, a provider whose return on equity capital is adjusted may compute the adjustment to average equity capital for each cost period affected under the month-by-month calculation described in §1220.)

136.14 Computation of Return on Equity Capital.--The return on equity capital for each period is computed by applying the rate of return and the ration that the program's share of allowable health insurance cost bears to total costs to the increase in average equity capital. This computation is illustrated in the example in §136.15A.

136.15 Computation of Recovery of Amounts Paid for Depreciation in Excess of Straight Line.--A. Illustration of the Methodology for Computing the Recovery of Amounts Paid in Excess of Straight Line Depreciation and the increase in the Return on Equity Capital.--

## SCHEDULE A

Provider name \_\_\_\_\_ Provider # \_\_\_\_\_ Period Ending 12/31/67

1-	Program recovery of excess depreciation - from Section 136.6(B1), Example - 1, column 8, or Section 136.6(B2), Example _ Method 2, Line 11	<u>\$3973</u>
2-	Allowance in Lieu of Other Costs--see Section 136.10-- (proprietary providers 1½ %)	<u>60</u>
3-	Program recovery of excess depreciation and allowance in Lieu of other costs (Line 1 plus Line 2)	<u>\$4033</u>
4-	Less: Adjustment for return on equity capital - (From Schedule B, Line 11)	<u>(209)</u>
5-	Net recovery by program (Line 3 less Line 4)	<u>\$3824</u>

NOTE: This space reserved for schedule B period ending 12-31-67.

NOTE: This space reserved for schedule B period ending 12-31-68.

NOTE: This space reserved for schedule B period ending 12-31-69.

B. Example of Computation of Average Equity Capital for Period in Which Provider Showed a Zero Equity.

Facts: The cost report, SSA-1750, for the period June 30, 1968, as submitted by the provider showed a zero balance in column 8 of Schedule D for three months.

Average increase in equity for period December 31, 1968 as computed in Schedule B, Line 9, above	\$30630
Less: The percentage that the number of months having a zero balance bears to total months in the period	
$3/12 \times \$30630$	<u>7658</u>
Average increase in equity capital for period ending December 31, 1968	\$22972

136.16 Offset of Recovery of Amounts Paid in Excess of Straight-Line Depreciation.--The total recovery of those amounts paid in excess of straight-line depreciation is applied as an offset to payments due the provider, or, if the provider has terminated participation in the program, as an overpayment. Where the amount of the excess depreciation to be recovered and the adjustment in the allowance in lieu of other costs is less than the increase in the reimbursable return on equity capital, no adjustment is made.