

sum of the fee schedule amounts payable for the same services when furnished by participating physicians in their offices in the same locality less deductible and coinsurance as defined in section 1866(a)(2)(A)(ii) of the Act.

[56 FR 8842, Mar. 1, 1991, as amended at 57 FR 36017, Aug. 12, 1992; 65 FR 18542, Apr. 7, 2000]

§413.123 Payment for screening mammography performed by hospitals on an outpatient basis.

(a) *Basis and scope.* This section implements section 1834(c)(1)(C) of the Act and establishes the method for determining Medicare payment for screening mammographies performed by hospitals.

(b) *Payment to hospitals for outpatient services.* Payment to hospitals for screening mammography services performed on an outpatient basis is determined in accordance with the technical component billing requirements in §405.534(d) of this chapter.

[55 FR 53522, Dec. 31, 1990, as amended at 59 FR 49834, Sept. 30, 1994]

§413.124 Reduction to hospital outpatient operating costs.

(a) Except for sole community hospitals, as defined in §412.92 of this chapter, and critical access hospitals, the reasonable costs of outpatient hospital services (other than capital-related costs of these services) are reduced by 5.8 percent for services furnished during portions of cost reporting periods occurring on or after October 1, 1990 and until the first date that the prospective payment system under part 419 of this chapter is implemented.

(b) For purposes of determining the blended payment amounts of ambulatory surgical center approved surgical procedures performed in the hospital outpatient setting under §413.118 and hospital outpatient radiology services and other diagnostic procedures under §413.122, the reduction is applicable only to the hospital-specific portion of the blended payment amounts.

[57 FR 36017, Aug. 12, 1992, as amended at 59 FR 26960, May 25, 1994; 62 FR 46037, Aug. 29, 1997; 65 FR 18542, Apr. 07, 2000]

§413.125 Payment for home health agency services.

(a) For additional rules on the allowability of certain costs incurred by home health agencies, see §§409.46 and 409.49(b) of this chapter.

(b) The reasonable cost of outpatient rehabilitation services furnished by a home health agency to homebound patients who are not entitled to home health benefits may not exceed the amounts payable under the physician fee schedule for comparable services effective January 1, 1999.

[59 FR 65497, Dec. 20, 1994, as amended at 63 FR 58910, Nov. 2, 1998]

Subpart G—Capital-Related Costs

§413.130 Introduction to capital-related costs.

(a) *General rule.* Capital-related costs and an allowance for return on equity are limited to the following:

(1) Net depreciation expense as determined under §§413.134, 413.144, and 413.149, adjusted by gains and losses realized from the disposal of depreciable assets under §413.134(f).

(2) Taxes on land or depreciable assets used for patient care.

(3) Leases and rentals, including license and royalty fees, for the use of depreciable assets or land, as described in paragraph (b) of this section.

(4) The costs of betterments and improvements as described in paragraph (c) of this section.

(5) The costs of minor equipment that are capitalized, rather than expensed, as described in paragraph (d) of this section.

(6) Insurance expense on depreciable assets, as described in paragraph (e) of this section.

(7) Interest expense as determined under §413.153, subject to the qualifications of paragraph (f) of this section.

(8) For certain proprietary providers, return on equity capital, as determined under §413.157.

(9) The capital-related costs of related organizations (as described in §413.17), as determined in accordance with paragraph (g) of this section.

(10) Debt issuance costs, debt discounts, and debt redemption costs, if

the associated debt was incurred to acquire land or depreciable assets used for patient care or to refinance existing debt for which the original purpose was to acquire land or depreciable assets used for patient care.

(11) The apportionment of the capital-related costs of jointly owned assets among the owners must be on a basis that reflects the relative use by each owner, rather than the ownership share or the amount of time the asset is located at each owners site.

(b) *Leases and rentals.* (1) Subject to the qualifications of paragraphs (b) (2), (4), (5), and (8) of this section, leases and rentals, including licenses and royalty fees, are includable in capital-related costs if they relate to the use of assets that would be depreciable if the provider owned them outright or they relate to land, which is neither depreciable nor amortizable if owned outright. The terms “*leases*” and “*rentals of assets*” signify that a provider has possession, use, and enjoyment of the assets.

(2) For sale and leaseback agreements for hospitals and SNFs entered into before October 23, 1992 and for sale and leaseback agreements for other providers entered into at any time, a provider may include incurred rental charges in its capital-related costs, as specified in a sale and leaseback agreement with a nonrelated purchaser (including shared service organizations not related within the meaning of § 413.17) involving plant facilities or equipment only if the following conditions are met:

(i) The rental charges are reasonable based on the following—

(A) Consideration of rental charges of comparable facilities and market conditions in the area;

(B) The type, expected life, condition, and value of the facilities or equipment rented; and

(C) Other provisions of the rental agreements.

(ii) Adequate alternative facilities or equipment that would serve the purpose are not or were not available at lower cost.

(iii) The leasing was based on economic and technical considerations.

(3) If the conditions of paragraph (b)(2) of this section are not met, the

amount a provider may include in its capital-related costs as rental or lease expense under a sale and leaseback agreement may not exceed the amount that the provider would have included in its capital-related costs had the provider retained legal title to the facilities or equipment, such as interest on mortgage, taxes, depreciation, and insurance costs.

(4) For sale and leaseback agreements for hospitals and SNFs entered into on or after October 23, 1992, the amount a provider may include in its capital-related costs as rental or lease expense may not exceed the amount that the provider would have included in its capital-related costs had the provider retained legal title to the facilities or equipment, such as interest expense on mortgages, taxes, depreciation, and insurance costs (the costs of ownership). This limitation applies both on an annual basis and over the useful life of the asset.

(i) If in the early years of the lease, the annual rental or lease costs are less than the annual costs of ownership, but in the later years of the lease the annual rental or lease costs are more than the annual costs of ownership, in the years that the annual rental or lease costs are more than the annual costs of ownership, the provider may include in capital-related costs annually the actual amount of rental or lease costs. The aggregate rental or lease costs included in capital-related costs may not exceed the aggregate costs of ownership that would have been included in capital-related costs over the useful life of the asset had the provider retained legal title to the asset.

(ii) If in the early years of the lease, the annual rental or lease costs exceed the annual costs of ownership, but in the later years of the lease the annual rental or lease costs are less than the annual costs of ownership, the provider may carry forward amounts of rental or lease costs that were not included in capital-related costs in the early years of the lease due to the costs of ownership limitation, and include these amounts in capital-related costs in the years of the lease when the annual rental or lease costs are less than the annual costs of ownership.

(iii) In any given year the amount of actual annual rental or lease costs plus the amount carried forward to that year may not exceed the amount of the costs of ownership for that year.

(iv) In the aggregate, the amount of rental or lease costs included in capital-related costs may not exceed the amount of the costs of ownership that the provider could have included in capital-related costs had the provider retained legal title to the asset.

(5) For lease purchase transactions entered into before October 23, 1992, a lease that meets the following conditions establishes a virtual purchase:

(i) The rental charge exceeds rental charges of comparable facilities or equipment in the area.

(ii) The term of the lease is less than the useful life of the facilities or equipment.

(iii) 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 that 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.

(6)(i) If a lease is a virtual purchase under paragraph (b)(5) of this section, the rental charge is includable in capital-related costs only to the extent that it does not exceed the amount that the provider would have included in capital-related costs if it had legal title to the asset (the cost of ownership), such as straight-line depreciation, insurance, and interest. A provider may not include in its capital-related costs accelerated depreciation in this situation.

(ii) The difference between the amount of rent paid and the amount of rent allowed as capital-related costs is considered a deferred charge and is capitalized as part of the historical cost of the asset when the asset is purchased.

(iii) If an asset is returned to the owner, instead of being purchased, the deferred charge may be included in capital-related costs in the year the asset is returned.

(iv) 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 included in capital-related costs to the extent of increasing the reduced rental to an amount not in excess of the cost of ownership.

(v) 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 included in the capital-related costs to the extent of increasing the reduced rental to a fair rental value.

(7) Amounts included in lease or rental payments for repair or maintenance agreements are excluded from capital-related costs. If no amount is identified in the lease or rental agreement for maintenance, the entire lease payment is considered a capital-related cost subject to the provisions of paragraph (b)(1) of this section.

(8) For lease purchase transactions entered into on or after October 23, 1992, a lease that meets any one of the following conditions establishes a virtual purchase:

(i) The lease transfers title of the facilities or equipment to the lessee during the lease term.

(ii) The lease contains a bargain purchase option.

(iii) The lease term is at least 75 percent 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.

(iv) The present value of the minimum lease payments (payments to be made during the lease term including bargain purchase option, guaranteed residual value, and penalties for failure to renew) equals at least 90 percent 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. 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.

(9)(i) If a lease establishes a virtual purchase under paragraph (b)(8) of this section, the rental charge is includable in capital-related costs to the extent

that it does not exceed the amount that the provider would have included in capital-related costs if it had legal title to the asset (the cost of ownership). The cost of ownership includes straight-line depreciation, insurance, and interest. For purposes of computing the limitation on allowable rental cost in this paragraph, a provider may not include accelerated depreciation.

(ii) The difference between the amount of rent paid and the amount of rent allowed as capital-related costs is considered a deferred charge and is capitalized as part of the historical cost of the asset when the asset is purchased.

(iii) If an asset is returned to the owner instead of being purchased, the deferred charge may be included in capital-related costs in the year the asset is returned.

(iv) 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 included in capital-related costs to the extent of increasing the reduced rental to an amount not in excess of the cost of ownership.

(v) 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 included in capital-related costs to the extent of increasing the reduced rental to a fair rental value.

(vi) 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 on rental charges in paragraph (b)(9)(i) of this section, must be used in calculating the limitation on adjustments for the purpose of determining any gain or loss under § 413.134(f) upon disposal of an asset.

(c) *Betterments and improvements.* (1) Betterments and improvements are changes which extend the estimated useful life of an asset at least two years beyond its original estimated useful life, or increase the productivity of an asset significantly over its original productivity.

(2) A provider must capitalize and prorate the costs of betterments and improvements over the remaining estimated useful life of the asset, as modified by the betterment or improvement.

(d) *Minor equipment.* A provider must include in its capital-related costs the costs of minor equipment that are capitalized rather than charged off to expense if—

(1) The net book value of minor equipment at the time the provider enters the program is prorated over three years (that is, one-third of the net book value is written off each year), and new purchases are also prorated over a 3-year period; or

(2) The cost of minor equipment is prorated over their actual useful lives.

(e) *Insurance.* (1) A provider must include in its capital-related costs the costs of insurance on depreciable assets used for patient care or insurance that provides for the payment of capital-related costs during business interruption.

(2) If an insurance policy also provides protection for other than the replacement of depreciable assets or to pay capital-related costs in the case of business interruption insurance, only that portion of the premium related to the replacement of depreciable assets or to pay capital-related costs in the case of business interruption insurance is includable in capital-related costs.

(f) *Debt premiums and debt discounts.* Debt premiums or debt discount are applied as adjustments to capital-related costs if the associated debt is incurred for acquiring land or depreciable assets used for patient care or for refinancing existing debt for which the original purpose was to acquire land or depreciable assets used for patient care.

(g) *Interest expense.* (1) A provider must include in its capital-related costs interest expense, as described in § 413.153, if such expense is incurred in—

(i) Acquiring land or depreciable assets (either through purchase or lease) used for patient care; or

(ii) Refinancing existing debt, if the original purpose of the refinanced debt was to acquire land or depreciable assets used for patient care.

(2) If investment income offset is required under § 413.153(b)(2)(iii), only

that portion of investment income that bears the same relationship to total investment income, as the portion of capital-related interest expense bears to total interest expense, is offset against capital-related costs.

(h) *Costs of supplying organizations—*
(1) *Supplying organizations related to the provider.* (i) If the supplying organization is related to the provider within the meaning of §413.17, except as provided in paragraph (g)(1)(ii) of this section, a provider's capital-related costs include the capital-related costs of the supplying organization.

(ii) If the costs of the services, facilities or supplies being furnished exceed the open market price, or if the provisions of §413.17(d) apply, no part of the cost to the provider of the services, facilities, or supplies are considered capital-related costs, unless the services, facilities, or supplies would otherwise be considered capital-related.

(2) *Supplying organizations not related to the provider.* If the supplying organization is not related to the provider within the meaning of §413.17, no part of the charge to the provider may be considered a capital-related cost (unless the services, facilities, or supplies are capital-related in nature) unless—

(i) The capital-related equipment is leased or rented (as described in paragraph (b) of this section) by the provider;

(ii) The capital-related equipment is located on the provider's premises, or is located offsite and is on real estate owned, leased or rented by the provider; and

(iii) The capital-related portion of the charge is separately specified in the charge to the provider.

(i) *Costs excluded from capital-related costs.* The following costs are not capital-related costs. To the extent that they are allowable, they must be included in determining each provider's operating costs:

(1) Costs incurred for the repair or maintenance of equipment or facilities.

(2) Amounts included in rentals or lease payments for repair or maintenance agreements.

(3) Interest expense incurred to borrow working capital (for operating expenses).

(4) General liability insurance or any other form of insurance to provide protection other than for the replacement of depreciable assets or to pay capital-related costs in the case of business interruption.

(5) Taxes other than those assessed on the basis of some valuation of land or depreciable assets used for patient care. (Taxes not related to patient care, such as income taxes, are not allowable, and are therefore not included among either capital-related or operating costs.)

(6) The costs of minor equipment that are charged off to expense rather than capitalized as described in paragraph (d) of this section.

(7) The costs incurred for maintenance and repair insurance agreements (commonly referred to as maintenance agreements).

(j) *Reduction to capital-related costs.* (1) Except for sole community hospitals and critical access hospitals, the amount of capital-related costs of all hospital outpatient services is reduced by—

(i) 15 percent for portions of cost reporting periods occurring on or after October 1, 1989, through September 30, 1991; and

(ii) 10 percent for portions of cost reporting periods occurring on or after October 1, 1991 and until the first date that the prospective payment system under part 419 of this chapter is implemented.

(2) For purposes of determining the blended payment amounts for hospital outpatient services under §§413.118 and 413.122, the reduction is applicable only to the hospital-specific portion of the blended amounts.

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§413.134 Depreciation: Allowance for depreciation based on asset costs.

(a) *Principle.* An appropriate allowance for depreciation on buildings and equipment used in the provision of patient care is an allowable cost. The depreciation must be—

(1) Identifiable and recorded in the provider's accounting records;

(2) Based on the historical cost of the asset, except as specified in paragraph (j) of this section regarding donated assets; and

(3) Prorated over the estimated useful life of the asset using—

(i) The straight-line method; or

(ii) Accelerated depreciation under a declining balance method (not to exceed double the straight-line rate) or the sum-of-the-years' digits method in the following situations:

(A) Depreciable assets for which accelerated depreciation was used for Medicare purposes before August 1, 1970, including those assets for which a timely request to change from straight-line depreciation to accelerated depreciation was received by an contractor before August 1, 1970;

(B) Depreciable assets acquired before August 1, 1970, if no election to use straight-line or accelerated depreciation was in effect on August 1, 1970, and the provider was participating in the program on August 1, 1970;

(C) Depreciable assets of a provider if construction of such depreciable asset began before February 5, 1970, and the provider was participating in the program on February 5, 1970; or

(D) Depreciable assets of a provider if a valid written contract was entered into by a provider participating in the program before February 5, 1970, for construction, acquisition, or for the permanent financing thereof, and such contract was binding on a provider on February 5, 1970, and at all times thereafter; or

(iii) A declining balance method, not to exceed 150 percent of the straight-line rate, for a depreciable asset acquired after July 31, 1970; however, this declining balance method may be used only if the cash flow from depreciation on the total assets of the institution 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 debts related to the provider's total de-

preciable assets. For each depreciable asset for which a provider requests authorization to use a declining balance method for Medicare reimbursement purposes, but not to exceed 150 percent of the straight-line rate, the provider must demonstrate to the contractor's satisfaction that the required cash flow need exists. For each depreciable asset in which a provider justifies the use of accelerated depreciation, the contractor must give written approval for the use of a depreciation method other than straight-line before basing any interim payment on this accelerated depreciation or making its reasonable cost determination which includes an allowance for such depreciation.

(b) *General rules*—(1) *Historical cost*. Historical cost is the cost incurred by the present owner in acquiring the asset.

(i) *All providers*—(A) *Depreciable assets acquired after July 31, 1970 and before December 1, 1997*. For depreciable assets acquired after July 31, 1970 and before December 1, 1997, and for a hospital or an SNF, acquired before July 18, 1984, the historical cost may not exceed the lower of current reproduction cost adjusted for straight-line depreciation over the life of the asset to the time of the purchase or the fair market value of the asset at the time of its purchase.

(B) *Depreciable assets acquired on or after December 1, 1997*. For depreciable assets acquired on or after December 1, 1997, the historical cost of the asset that will be recognized under this program must not exceed 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). For this paragraph (b)(1)(i)(B), 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 acquisition cost to the owner of record is subject to the limitation on historical costs described in paragraphs (g) (1), (2), and (3) 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 §§413.153(d) and 413.157(b) for application of the limitation to the cost of land for purposes of determining the allowable interest expense.)

(3) Acquisition cost to the owner of record includes the costs of betterment or improvements that extend the estimated useful life of an asset at least 2 years beyond its original estimated useful life or that increase the productivity of an asset significantly over its original productivity.

(4) For assets acquired prior to a provider's entrance into the Medicare program, the acquisition 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 acquisition cost to the owner of record is the historical cost established for those assets when the provider changed to actual depreciation as described in §413.139(e). If the provider did not change to actual depreciation, as described in §413.139(e), for optional allowance assets, the acquisition 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 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 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 contractor under paragraph (f)(2)(iv) of this section), legal fees, accounting and administrative costs, travel costs, and the costs of feasibility studies.

(ii) *Hospitals and SNFs only.* (A) For assets acquired on or after July 18, 1984 and before December 1, 1997 and not subject to an enforceable agreement entered into before July 18, 1984, historical cost may not exceed the lowest of the following:

(1) The allowable acquisition cost 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.

(B) For purposes of applying paragraph (b)(1)(ii)(A) of this section, 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.

(C) The acquisition cost to the owner of record is subject to any limitation on historical costs described in paragraphs (b)(1)(i) or (g)(1) and (2) of this section, and is not reduced by any depreciation taken by the owner of record. This limitation on historical cost is also applied to the purchase of land, a capital asset that is neither depreciable nor amortizable under any circumstances. (See §§413.153(d) and 413.157(b) for application of the limitation to the cost of land for purposes of determining allowable interest expense and return on equity capital or proprietary providers.)

(D) Acquisition cost to the owner of record includes the costs of betterments or improvements that extend the estimated useful life of an asset at least two years beyond its original estimated useful life or increase the productivity of an asset significantly over its original productivity.

(E) For assets acquired prior to a hospital's or SNF's entrance into the Medicare program, the acquisition cost to the owner of record is the historical cost of the asset when acquired, rather than when the hospital or SNF entered the program.

(F) For assets subject to the optional depreciation allowance as described in §413.139, the acquisition cost to the owner of record is the historical cost established for those assets when the hospital or SNF changed to actual depreciation as described in §413.139(e). If the hospital or SNF did not change to actual depreciation, as described in §413.139(e), 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.

(G) The historical cost of an asset acquired on or after July 18, 1984 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 contractor under paragraph (f)(2)(iv) of this section), legal fees, accounting and administrative costs, travel costs, and the costs of feasibility studies.

(iii) *Hospital-based providers other than SNFs and SNF-based providers.* For changes of ownership that involve assets of a hospital-based provider other than a SNF, or assets of a SNF-based provider, the provisions of paragraph (b)(1)(ii) of this section are not applicable. A reasonable allocation of the purchase price must be made, so that the hospital-based provider other than a SNF, or a SNF-based provider, is not affected by the limitations described in paragraph (b)(1)(ii) of this section. The historical cost of assets of providers other than hospitals and SNFs is governed by paragraph (b)(1)(i) of this section.

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

(3) *The straight-line method.* Under the straight-line method of depreciation, the cost or other basis (for example, fair market value in the case of donated assets) of the asset, less its estimated salvage value, if any, is determined first. Then this amount is distributed in equal amounts over the period of the estimated useful life of the asset.

(4) *Declining balance method.* Under the declining balance method, the annual depreciation allowance is computed by multiplying the undepreciated cost of the asset each year by a uniform rate up to double the straight-line rate or 150 percent, as the case may be (see paragraph (a)(3) of this section for limitations on use of accelerated methods of depreciation).

(5) *Sum-of-the-years' digits method.* Under the sum-of-the-years' digits method, the annual depreciation allowance is computed by multiplying the depreciable cost basis (cost less salvage value) by a constantly decreasing fraction. The numerator of the fraction is represented by the remaining years of useful life of the asset at the beginning of each year, and the denominator is always represented by the sum of the years' digits of useful life at the time of acquisition.

(6) *Current reproduction cost.* Current reproduction cost is the cost at current prices, in a particular locality or market area, of reproducing an item of property or a group of assets. Where depreciable assets are concerned, this means the reasonable cost to have built, reproduce in kind, or, in the case of equipment or similar assets, to purchase in the competitive market.

(7) *Useful life.* The estimated useful life of a depreciable asset is its normal operating or service life to the provider, subject to the provisions in paragraph (b)(7)(i) of this section. Factors to be considered in determining useful life 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.

(i) *Initial selection of useful life.* In selecting a proper useful life for computing depreciation under the Medicare program, providers must use the useful life guidelines published by CMS. If CMS has not published applicable useful life guidelines, providers must use—

(A) The edition of the American Hospital Association useful life guidelines, as specified in CMS Medicare program manuals; or

(B) A different useful life specifically requested by the provider and approved by the contractor. A different useful

life may be approved by the contractor if the provider's request is properly supported by acceptable factors that affect the determination of useful life. However, such factors as an expected early sale, retirement, demolition or abandonment of an asset, or termination of the provider from the Medicare program may not be used.

(ii) *Application of guidelines.* The provisions concerning the selection of useful life guidelines described in paragraph (b)(7)(i) of this section apply to assets acquired on or after January 1, 1981. For assets acquired before January 1, 1981, providers must use the useful life guidelines published by the American Hospital Association in its 1973 edition of *Chart of Accounts for Hospitals*, or those published by the Internal Revenue Service, or those approved for use by contractors as provided in paragraph (b)(7)(i)(B) of this section.

(iii) *Changing useful life.* A change in the estimated useful life may be made if clear and convincing evidence justifies a redetermination of the useful life used by the provider. Such a change must be approved by the contractor in writing, and the factors cited in paragraphs (b)(7) and (b)(7)(i) of this section 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.

(8) *Donated asset.* An asset is considered donated when the provider acquires the asset without making payment in the form of cash, new debt, assumed debt, property or services. Except as provided in paragraph (j)(3) of this section, if a provider makes payment in any form to acquire an asset, the payment is considered the purchase price for the purpose of determining allowable historical cost.

(9) *Net book value.* The net book value of an asset is the depreciable basis used for the Medicare program by the asset's last participating owner less depreciation recognized under the Medicare program.

(c) *Recording of depreciation.* Appropriate recording of depreciation includes the identification of the depre-

ciable assets in use, the assets' historical costs, the assets' dates of acquisition, the method of depreciation, estimated useful lives, and the assets' accumulated depreciation.

(d) *Depreciation methods*—(1) *General.* Proration of the cost of an asset over its useful life is allowed on the straight-line method, or, when permitted under paragraph (a)(3) of this section, the declining balance or the sum-of-the-years' digits methods. One method may be used on a single asset or group of assets and another method on others. In applying the declining balance or sum-of-the-years' digits method to an asset that is not new, the undepreciated cost of the asset is treated as the cost of a new asset in computing depreciation.

(2) *Change in method.* Prior to August 1, 1970, a provider may change from the straight-line method to an accelerated method or vice versa, upon advance approval from the contractor on a prospective basis 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 may be made by a provider. Effective with August 1, 1970, a provider may only change from an accelerated method or optional method (see §413.139) to the straight-line method. Such a change may be made without contractor approval and the basis for depreciation is the undepreciated cost reduced by the salvage value. Thereafter, once straight-line depreciation is selected for a particular asset, an accelerated method may not be established for that asset.

(3) *Recovery of accelerated depreciation*—(i) *General.* If a provider who has used an accelerated method of depreciation for any of its assets terminates participation in the program, or if the Medicare proportion of its allowable costs decreases so that cumulatively substantially more depreciation was paid than would have been paid using the straight-line method of depreciation, the excess of reimbursable cost determined by using accelerated depreciation methods and paid under the program over the reimbursable cost that 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. In this determination of excess payment, recognition will be given to the effects the adjustment to straight-line depreciation would have on the return on equity capital and on the allowance in lieu of specific recognition of other costs in the respective years.

(ii) *Transaction between related organizations*—(A) *General*. If the termination of the provider agreement is due to a change in provider ownership, as defined in § 489.18 of this chapter, resulting from a transaction between related organizations, as defined in § 413.17, and the criteria in paragraph (b) of this section are met, the excess of reimbursable cost, as determined in paragraph (d)(3)(i) of this section may not be recovered if there is a continuation of participation by the facility in the Medicare program.

(B) *Criteria*. The following criteria must be met if the recovery of excess reimbursable cost is not to be made:

(1) The termination of the provider agreement is due to a change in ownership of the provider resulting from a transaction between related organizations.

(2) The successor provider continues to participate in the Medicare program.

(3) Control and the extent of the financial interest of the owners of the provider before and after the termination remain the same; that is, the successor owners acquire the same percentage of control or financial investment as the transferors had.

(4) All assets and liabilities of the terminated provider are transferred to the related successor participating provider.

(C) *Effect of transaction*. In transactions meeting the criteria specified in paragraph (d)(3)(ii)(B) of this section, the provision concerning recovery of excess reimbursable cost (§ 413.134(d)(3)(i)) is not applied, and the transaction is treated as follows:

(1) The successor provider must record the historical cost and accumulated depreciation and the method of depreciation recognized under the Medicare program, and these are con-

sidered as incurred by the successor provider for Medicare purposes.

(2) The Medicare program's utilization of the terminated provider is considered as having been incurred by the successor provider for Medicare purposes.

(3) The equity capital of the terminated provider as of the closing of its final cost reporting period must be wholly contained in the equity capital of the successor provider as of the beginning of its first cost reporting period.

(e) *Funding of depreciation*. Although funding of depreciation is not required, it is strongly recommended that providers use this mechanism as a means of conserving funds for replacement of depreciable assets. Funded depreciation account funds must be placed in readily marketable investments of the type that assures the availability and conservation of the funds. Additions to the funded depreciation account must remain in the account for at least 6 months to be considered valid funding transactions.

(1) *Incentive*. As an incentive for funding, investment income on funded depreciation is not treated as a reduction of allowable interest expense provided such investment income is deposited in, and becomes part of, the funded depreciation account at the time of receipt by the provider. Investment income earned on deposits before the 6-month period elapses are not offset unless the deposits are withdrawn for an improper purpose during this period. If a provider transfers assets of the funded depreciation account to a related organization (for example, pooling of several chain organization providers' funded depreciation accounts at the chain home office for investment purposes), these assets shall be treated as the provider's funds and are subject to all the requirements specified in paragraph (e) of this section.

(2) *Availability of funded depreciation*. (i) CMS considers funded depreciation available for use in the acquisition or replacement of depreciable assets related to patient care unless the funded depreciation funds have been committed by contract for the acquisition

of depreciable assets related to the furnishing of patient care or for other capital purposes related to patient care.

(ii) Borrowing for a purpose for which funded depreciation account funds should have been used makes the borrowing unnecessary to the extent that funded depreciation account funds were available at the time of the borrowing. Available funds in the funded depreciation account, to the extent of the unnecessary borrowing, are called “tainted” funds. Interest expense incurred on borrowing for a capital purpose is not an allowable cost to the extent that funded depreciation account funds were available at the time of the borrowing.

(iii) A provider can remove the “unnecessary” characterization of borrowing, and thereby cure tainted funded depreciation, by using the tainted funds for a proper purpose described in paragraph (e)(3)(i) of this section. However, any funded depreciation that existed at the time of the unnecessary borrowing and is not classified as tainted must be used before any of the tainted funds.

(iv) When only a portion of the borrowing is considered unnecessary under paragraph (e)(2)(ii) of this section, subsequent repayments of such borrowing from general funds are applied first to the allowable portion of the borrowing and then, when all of the allowable borrowing is repaid, to the unallowable portion of the borrowing. When funds from the funded depreciation account are used for the repayment of the unnecessary borrowing, an equivalent amount of tainted funds is cured without regard to the provisions of paragraphs (e)(2)(ii) and (e)(3)(i)(C) of this section. Similarly, where general funds are used to pay for the unallowable borrowing after the necessary borrowing has been repaid, an equivalent amount of tainted funded depreciation is cured without regard to the provisions of paragraphs (e)(2)(ii) and (e)(3)(i)(C) of this section.

(3) *Withdrawals of funded depreciation*—(i) *Proper withdrawals*. (A) Withdrawals from funded depreciation are considered proper if made either for the acquisition or replacement of depreciable assets related to the fur-

nishing of patient care or for other capital purposes related to patient care.

(B) *First-in, first-out basis*. Proper withdrawals from funded depreciation are made on a first-in, first-out basis.

(C) *Exception*. If CMS determines that a borrowing is unnecessary because of the existence of available funded depreciation, and additional deposits have been made to funded depreciation after the occurrence of the unnecessary borrowing, withdrawals made after the date of the additional deposits are deemed to be made on a last-in, first-out basis.

(ii) *Improper withdrawals*. (A) Withdrawals from funded depreciation that do not meet the requirements for proper withdrawals under the provisions in paragraph (e)(3)(i)(A) of this section are considered improper withdrawals.

(B) Improper withdrawals from funded depreciation are made on a last-in, first-out basis. If improper withdrawals are made, interest expense is reduced in accordance with section §413.153(c)(3).

(C) Improper withdrawals will result in the offset of otherwise allowable interest expense under the offset provisions in §413.153(c)(3).

(4) *Loans from funded depreciation*. (i) When the general fund of the provider borrows from the funded depreciation to obtain working capital for normal operating expenses to furnish patient care, interest incurred by the general fund is an allowable operating cost only if the interest expense is supported by documents that evidence that the funds were borrowed and that payment of interest and repayment of the funds are required, is separately identified in the provider's accounting records, and meets the necessary and proper tests described in §§413.153(b)(2) and (b)(3). However, if the general fund of the provider borrows from the funded depreciation account to acquire depreciable assets used in furnishing patient care, or for other capital purposes related to patient care, interest expense paid by the general fund to the funded depreciation account is not an allowable cost. Providers are expected to use the funded depreciation for these purposes.

(ii) Loans from funded depreciation to the general fund are considered investments of funded depreciation, but do not have to meet the readily marketable test described in paragraph (e) of this section. Loans made from funded depreciation are subject to the requirement that funded depreciation must be available for the acquisition of depreciable assets used to furnish patient care, or for other capital purposes related to patient care. Costs incurred to secure lines of credit from lending institutions to ensure such availability are not allowable costs.

(iii) Funding of depreciation from general funds will not be recognized to the extent of any outstanding loans from the funded depreciation account to the general fund. Deposits from the general fund into the funded depreciation account must be first applied to reduce any loans outstanding from the funded depreciation to the general fund. When the loans are repaid in full, general funds deposited in the funded depreciation account are considered as repayments of the general fund. Therefore, any subsequent interest expense of the general fund paid to the funded depreciation fund is not an allowable cost.

(iv) A provider may loan its funded depreciation to a related organization for any purpose subject to the following conditions:

(A) Authorization for such a loan by the provider's appropriate managing body of the provider, such as Board of Trustees or Board of Directors, must be on file.

(B) The funded depreciation loaned must remain available, as specified in paragraph (e)(2) of this section, to the provider making the loan. Costs incurred for lines of credit to assure such availability are not allowable costs. During the period of time that the loan is outstanding, if the provider making the loan resorts to outside borrowing for a purpose for which its funded depreciation should have been used, interest expense on an amount of the outside borrowing up to the amount of the funded depreciation that should have been available would be disallowed as unnecessary.

(C) Such loans shall be considered investments of the provider's funded de-

preciation, but the requirement that funded depreciation be invested in readily marketable investments as required in paragraph (e) of this section is waived for such loans.

(D) The funded depreciation account must earn interest on such loans at a rate that does not exceed the rate that would be charged for a comparable loan from an independent lending institution. This investment income will not be used to reduce the provider's interest expense if all the other conditions in paragraph (e) of this section are met. If the entity borrowing the funds is another provider participating in the Medicare program, the interest expense incurred on such loans would be allowable if the loan meets all of the interest expense requirements specified in § 413.153. (For purposes of § 413.153(b)(3)(ii), such loans are not considered to be with a related lender.)

(f) *Gains and losses on disposal of assets*—(1) *General*. Depreciable assets may be disposed of through sale, scrapping, trade-in, exchange, demolition, abandonment, condemnation, fire, theft, or other casualty.

(i) *Disposal of an asset before December 1, 1997*. If disposal of a depreciable asset, including the sale or scrapping of an asset before December 1, 1997, results in a gain or loss, an adjustment is necessary in the provider's allowable cost.

(A) The amount of a gain included in the determination of allowable cost is limited to the amount of depreciation previously included in Medicare allowable costs.

(B) The amount of a loss to be included is limited to the undepreciated basis of the asset permitted under the program.

(C) The treatment of the gain or loss depends upon the manner of disposition of the asset, as specified in paragraphs (f)(2) through (6) of this section.

(D) The gain or loss on the disposition of depreciable assets has no retroactive effect on a proprietary provider's equity capital for years prior to the year of disposition.

(ii) *Disposal of an asset on or after December 1, 1997*. No gain or loss is recognized on either the sale or scrapping of an asset that occurs on or after December 1, 1997, regardless of whether the

asset is sold incident to a provider's change of ownership, or otherwise sold or scrapped as an asset of a Medicare participating provider. Gains or losses on dispositions other than sales or scrapping are recognized to the same extent as prior to December 1, 1997.

(2) *Bona fide sale or scrapping before December 1, 1997.* For the bona fide sale or scrapping of depreciable assets before December 1, 1997, the following apply:

(i) Except as specified in paragraph (f)(3) of this section, gains and losses realized from the bona fide sale or scrapping of depreciable assets are included in the determination of allowable cost only if the sale or scrapping occurs while the provider is participating in Medicare. The extent to which such gains and losses are included is calculated by prorating the basis for depreciation of the asset in accordance with the proportion of the asset's useful life for which the provider participated in Medicare. For purposes of this paragraph (f)(2)(i), scrapping refers to the physical removal from the provider's premises of tangible personal properties that are no longer useful for their intended purpose and are only salable for their scrap or junk value.

(ii) If the total amount of gains or losses realized from bona fide sales or scrapping does not exceed \$5,000 within the cost reporting period or if the provider's cumulative utilization under the Medicare program is less than 5 percent, the net amount of gains or losses realized from sale or scrapping will be allowed as a depreciation adjustment in the period of disposal. For purposes of this paragraph (f)(2)(ii), the provider's cumulative Medicare utilization percentage is determined by comparing the cumulative total of the Medicare inpatient days for all reporting periods in which depreciation on the asset disposed of was claimed under the Medicare program to the cumulative total of inpatient days of the participating provider for the same reporting periods.

(iii) If the conditions specified in paragraph (f)(2)(ii) of this section are not met, the adjustment to reimbursable cost in the reporting period of

asset disposition is calculated as follows:

(A) The total amount of gains or losses shall be allocated to all reporting periods under the Medicare program, based on the ratio of the depreciation allowed on the assets in each reporting period to the total depreciation allowed under the Medicare program.

(B) The results of this allocation are multiplied by the ratio of Medicare reimbursable cost to total allowable cost for each reporting period.

(C) The results of this multiplication are then added.

(D) Effective for cost reporting periods beginning on or after October 1, 1991, no adjustment will be made for the portion of gains or losses allocated to inpatient hospital services for which the hospital was paid under the fully prospective payment methodology as described in §412.340 of this chapter or under the hold-harmless methodology based on the Federal rate as described in §412.344(a)(1) of this chapter for new capital costs or in §412.344(a)(2) of this chapter.

(iv) If a provider sells more than one asset 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, 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 sales price, or if they do agree but there is insufficient documentation of the current fair market value of each asset, the contractor for the selling provider will require an appraisal by an independent appraisal expert to establish the fair market value of each asset and will make an allocation of the sales price in accordance with the appraisal.

(3) *Sale within 1 year after termination.* Gains and losses realized from a bona fide sale of depreciable assets within 1 year immediately following the date on which the provider terminates participation in the Medicare program are also included in the determination of allowable cost, in accordance with the procedure specified in paragraph (f)(2)

of this section. However, if several assets are sold for a lump sum sales price, the determination of fair market value must be based on the appraised value of the assets as they were last used by the provider while participating in the Medicare program.

(4) *Exchange, trade-in or donation.* Gains or losses realized from the exchange, trade-in, or donation of depreciable assets are not included in the determination of allowable cost. When the disposition of an asset is by means of exchange or trade-in, the historical cost of the new asset is the sum of the undepreciated cost of the asset disposed of and the additional 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) exceed 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.

(5) *Demolition or abandonment.* (i) For purposes of this section, the term “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 Medicare 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.

(ii) If losses resulting from the demolition or abandonment of depreciable assets do not exceed \$5,000 within the cost-reporting period, the losses are to be allowed in the period of disposal.

(iii) If losses exceed \$5,000 and, at the date of disposition, the demolished or abandoned assets are at least 80 percent depreciated as computed under the straight-line method, such losses are includable in the determination of allowable cost under the Medicare program in the period of disposal and the procedure provided in paragraph (f)(2)(iii) of this section must be used in determining the adjustment to reimbursable cost.

(iv) Losses in excess of \$5,000 resulting from the demolition or abandonment of assets, which at the date of disposition are not 80 percent depreciated as computed under the straight-line method, must be capitalized as a deferred charge and amortized as follows:

(A) If the State Health Planning and Development Agency (SHPDA) designated under section 1521 of the Public Health Service Act approves the demolition or abandonment of a depreciable asset as being consistent with the health systems plan of the health service area in which the provider is located, the net loss realized shall 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 contractor. The contractor, after reviewing this request and before issuing the approval, will submit the request along with its recommendation to the appropriate Regional Office for its approval.

(B) If a provider fails to obtain approval as specified in paragraph (f)(5)(iv)(A) of this section, a loss is not allowable unless the demolished or abandoned asset is replaced. If the asset is replaced, the loss resulting from the unapproved demolition or abandonment must be capitalized as a deferred charge and amortized over the estimated useful life of the replacement asset or at the rate of \$5,000 per year, whichever is greater.

(v) If a loss resulting from the demolition or abandonment is deferred and amortized and the provider terminates its participation in the Medicare program or ceases to use a replacement asset in the provision of patient care services, the unamortized deferred charge remaining at that time must not be included in determining allowable cost under the Medicare program.

(vi) Losses on demolition must include the demolition cost incurred by the provider for razing and removal of the asset, less any salvage value recovered by the provider. However, if a provider demolishes a depreciable 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) is considered a capital expenditure and added to the historical basis of the land.

(vii) If a provider purchases land on which there is a building, no depreciation will be allowed under the Medicare program unless the building is used in providing patient care. If the building is demolished, the entire purchase price and demolition cost shall be considered the historical cost of the land. 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 will be considered the historical cost of the land.

(6) *Involuntary conversion.* (i) Losses resulting from the involuntary conversion of depreciable assets, such as condemnation, fire, theft, or other casualty, are generally included in the determination of allowable cost on a deferred basis if the asset is restored or replaced. However, losses resulting from a provider's imprudent management of its depreciable assets, such as the failure to obtain proper insurance coverage, are not included in the determination of allowable cost.

(ii) The net allowable loss from involuntary conversion must consist of the undepreciated cost of unrecovered book value of the asset, less amounts received from insurance proceeds gifts, and grants received from local, State, or Federal government, or any other source as a result of the involuntary conversion.

(iii) If the asset is replaced and the net allowable loss in any cost-reporting period does not exceed \$5,000, the entire amount must be included in allowable cost in the period in which the loss is incurred. If the asset is replaced and the net 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 replacement or restored asset. If a replaced or restored asset 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

will not be included in determining allowable cost under the Medicare program.

(iv) If the provider fails to replace or restore an involuntarily converted asset, the loss is not included in determining allowable cost. However, if the provider intends to replace or restore the asset but is unable to do so because the designated SHPDA finds such replacement or restoration to be inconsistent with the health systems 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 must be 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.

(v) If a gain is realized from an involuntary conversion of depreciable assets, the net amount realized reduces the basis of the restored or replacement asset. If the asset is not restored or replaced, the gain is to be treated in accordance with paragraph (f)(2) of this section.

(7) *Effect on equity capital.* The unrecovered loss entered on the books of the provider as a deferred charge, in accordance with paragraphs (f) (5) and (6) of this section, is not includable in the computation of equity capital under §413.157.

(8) *Sale of replacement or restored assets.* If a provider sells a replacement or restored asset while participating in the Medicare program or within 1 year immediately following the date on which it terminates its participation in the Medicare program, the unrecovered loss entered on the books of the provider as a deferred charge in accordance with paragraphs (f) (5) and (6) of this section 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 §413.17, and the purchasing organization continues as a provider in the Medicare program, the remaining deferred charge representing the unrecovered depreciable basis of the demolished, abandoned or destroyed asset must continue to be amortized over the remaining expected

useful life of the replacement or restored asset. If the sale is made to an unrelated organization, further amortization of the deferred charge is not allowed.

(g) *Establishment of cost basis on purchase of facility as an ongoing operation*—(1) *Assets acquired after July 1, 1966 and before August 1, 1970.* The cost basis for the assets of a facility purchased as an ongoing operation after July 1, 1966, and before August 1, 1970, is the lowest of the—

(i) Total price paid for the facility by the purchaser, as allocated to the individual assets of the facility;

(ii) Total fair market value of the facility at the time of the sale, as allocated to the individual assets; or

(iii) Combined fair market value of the individually identified assets at the time of the sale.

(2) *Assets acquired after July 31, 1970 and, for hospitals and SNFs, before July 18, 1984.* For depreciable assets acquired after July 31, 1970 and, for hospitals and SNFs, before July 18, 1984, in addition to the limitations specified in paragraph (g)(1) of this section, the cost basis of the depreciable assets may not exceed the current reproduction cost depreciated on a straight-line basis over the life of the asset to the time of the sale.

(3) *Assets acquired by hospitals and SNFs on or after July 18, 1984 and not subject to an enforceable agreement entered into before that date.* Subject to paragraphs (b)(1)(ii) (B) through (G) and (b)(1)(iii) of this section, historical cost may not exceed the lowest of the following:

(i) The allowable acquisition cost 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);

(ii) The acquisition cost to the new owner; or

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

(4) *Assets acquired by all providers on or after December 1, 1997.* Subject to the provisions of paragraph (b)(1)(i)(A) of this section, the historical cost may not exceed the historical cost of the asset, as recognized under the Medicare program, less depreciation allowed, to the owner of record as of August 5, 1997

(or for an asset not in existence as of August 5, 1997, the first owner of record after August 5, 1997).

(5) *Transactions other than bona fide.* If the purchaser cannot demonstrate that the sale was bona fide, in addition to the limitations specified in paragraph (g)(1), (2), and (3) of this section, the purchaser's cost basis may not exceed the seller's cost basis, less accumulated depreciation.

(h) *Sale and leaseback agreements and other lease transactions.* (1) For sale and leaseback agreements for all providers, and for sale and leaseback agreements for hospitals and SNFs entered into before October 23, 1992, a provider may include in its allowable costs incurred rental charges, as specified in a sale and leaseback agreement with a non-related purchaser involving plant facilities or equipment, only if—

(i) 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 agreement;

(ii) Adequate alternate facilities or equipment that would serve the purpose are not or were not available at lower cost; and

(iii) The leasing was based on economic and technical considerations.

(2) If the conditions of paragraph (h)(1) of this section are not met, the amount a provider may include in its allowable costs as rental or lease expense under a sale and leaseback agreement may not exceed the amount that the provider would have included in its allowable costs had the provider retained legal title to the facilities or equipment such as interest expense on mortgages, taxes, depreciation, and insurance costs.

(3) For hospitals and SNFs entering into sale and leaseback agreements on or after October 23, 1992, the amount a provider may include in its allowable costs 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 facilities or equipment, such as interest expense on

mortgages, taxes, depreciation, and insurance costs (the costs of ownership). This limitation applies both on an annual basis and over the useful life of the asset.

(i) If in the early years of the lease, the annual rental or lease costs are less than the annual costs of ownership, but in the later years of the lease the annual rental or lease costs are more than the annual costs of ownership, in the years that the annual rental or lease costs are more than the costs of ownership the provider may include in allowable costs annually the actual amount of rental or lease costs. The aggregate rental or lease costs included in allowable costs may not exceed the aggregate costs of ownership that would have been included in allowable costs over the useful life of the asset had the provider retained legal title to the asset.

(ii) If in the early years of the lease, the annual rental or lease costs exceed the annual costs of ownership, but in the later years of the lease the annual rental or lease costs are less than the annual costs of ownership, the provider may carry forward amounts of rental or lease costs that were not included in allowable costs in the early years of the lease due to the costs of ownership limitation, and include these amounts in allowable costs in the years of the lease when the annual rental or lease costs are less than the annual costs of ownership. In any given year the amount of actual annual rental or lease costs plus the amount carried forward to that year may not exceed the amount of the costs of ownership for that year.

(iii) In the aggregate, the amount of rental or lease costs included in allowable costs may not exceed the amount of the costs of ownership that the provider could have included in allowable costs had the provider retained legal title to the asset.

(4) For lease transactions of all providers entered into before October 23, 1992, a lease that meets the following conditions establishes a virtual purchase:

(i) The rental charge exceeds rental charges of comparable facilities or equipment in the area.

(ii) The term of the lease is less than the useful life of the facilities or equipment.

(iii) 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 that 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.

(5)(i) If a lease is a virtual purchase under paragraph (h)(4) of this section, the rental charge is includable in allowable costs only to the extent that it does not exceed the amount that 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 in this paragraph, a provider may not include accelerated depreciation.

(ii) The difference between the amount of rent paid and the amount of rent allowed as rental expense is considered a deferred charge and must be capitalized as part of the historical cost of the asset when the asset is purchased.

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

(iv) 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.

(v) 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.

(6) For lease transactions entered into on or after October 23, 1992, a lease that meets any one of the following conditions establishes a virtual purchase:

(i) The lease transfers title of the facilities or equipment to the lessee during the lease term.

(ii) The lease contains a bargain purchase option.

(iii) 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.

(iv) 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) equals 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.

(7)(i) If a lease is a virtual purchase under paragraph (h)(6) of this section, the rental charge is includable in allowable costs only to the extent that it does not exceed the amount that the provider would have included in allowable costs if it had legal title to the asset (the costs of ownership), such as straight-line depreciation, insurance, and interest. For purposes of computing the limitation on allowable rental cost as described in this paragraph, a provider may not include accelerated depreciation in its allowable costs.

(ii) The difference between the amount of rent paid and the amount of rent allowed as rental expense is considered a deferred charge and is capitalized as part of the historical cost of the asset when the asset is purchased.

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

(iv) 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.

(v) 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.

(vi) 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 paragraph (h)(7)(i) of this 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 paragraph (f) of this section.

(i) *Intergovernmental transfer of facilities.* The basis for depreciation of assets transferred under appropriate legal authority from one governmental entity to another is as follows:

(1) The historical cost incurred by the present owner in acquiring the asset under a bona fide sale. The historical cost may not exceed the lower of current reproduction cost adjusted for straight-line depreciation over the life of the asset to the time of the purchase of fair market value at the time of the purchase.

(2) The fair market value at the time of donation under a bona fide donation of the asset (subject to the limitations set forth under paragraph (i) of this section). An asset is considered donated when a governmental entity acquires the asset without assuming the functions for which the transferor used the asset or making any payment for it in the form of cash, property, or services.

(3) If neither paragraph (h) (1) nor (2) of this section applies, for example, 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—

(i) With respect to 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, as permitted under paragraph (d)(2) of this section; or

(ii) With respect to 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 the Medicare program) less depreciation calculated on the straight-line basis over the life of the asset to the time of transfer.

(j) *Basis of assets donated to a provider*—(1) Assets not used or depreciated under the 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 at the time of donation.

(2) *Assets used or depreciated under the Medicare program*. If an asset has 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 lesser of—

(i) The fair market value at the time of donation; or

(ii) The net book value in the hands of the owner last participating in the Medicare program.

(3) *Transfers of State hospitals to nonprofit corporations 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 purposes of this section, monetary consideration includes cash, new debt, and assumed debt.

(k) *Transactions involving a provider's capital stock*—(1) *Acquisition of capital stock of a provider*. If the capital stock of a provider is acquired, the provider's assets may not be revalued. For example, if Corporation A purchases the cap-

ital stock of Corporation B, the provider, Corporation B continues to be the provider after the purchase and Corporation A is merely the stockholder. Corporation B's assets may not be revalued.

(2) *Statutory merger*. A statutory merger is a combination of two or more corporations under the corporation laws of the State, with one of the corporations surviving. The surviving corporation acquires the assets and liabilities of the merged corporation(s) by operation of State law. The effect of a statutory merger upon Medicare reimbursement is as follows:

(i) *Statutory merger between unrelated parties*. If the statutory merger is between two or more corporations that are unrelated (as specified in §413.17), the assets of the merged corporation(s) acquired by the surviving corporation may be revalued in accordance with paragraph (g) of this section. If the merged corporation was a provider before the merger, then it is subject to the provisions of paragraphs (d)(3) and (f) of this section concerning recovery of accelerated depreciation and the realization of gains and losses. The basis of the assets owned by the surviving corporation are unaffected by the transaction. An example of this type of transaction is one in which Corporation A, a nonprovider, and Corporation B, the provider, are combined by a statutory merger, with Corporation A being the surviving corporation. In such a case the assets of Corporation B acquired by Corporation A may be revalued in accordance with paragraph (g) of this section.

(ii) *Statutory merger between related parties*. If the statutory merger is between two or more related corporations (as specified in §413.17), no revaluation of assets is permitted for those assets acquired by the surviving corporation. An example of this type of transaction is one in which Corporation A purchases the capital stock of Corporation B, the provider. Immediately after the acquisition of the capital stock of Corporation B, there is a statutory merger of Corporation B and Corporation A, with Corporation A being the surviving corporation. Under these circumstances, at the time of the merger the transaction is one between related parties

and is not a basis for revaluation of the provider's assets.

(3) *Consolidation.* A consolidation is the combination of two or more corporations resulting in the creation of a new corporate entity. If at least one of the original corporations is a provider, the effect of a consolidation upon Medicare reimbursement for the provider is as follows:

(i) *Consolidation between unrelated parties.* If the consolidation is between two or more corporations that are unrelated (as specified in § 413.17), the assets of the provider corporation(s) may be revalued in accordance with paragraph (g) of this section.

(ii) *Consolidation between related parties.* If the consolidation is between two or more related corporations (as specified in § 413.17), no revaluation of provider assets is permitted.

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§ 413.139 Depreciation: Optional allowance for depreciation based on a percentage of operating costs.

(a) *Principle.* With respect to 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 provider's 1965 operating costs or the provider's current year's allowable costs, whichever are the lower. The percentage 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 regular depreciation on assets acquired after 1965; however, if the optional allowance is selected, the combined amount of such allowance on pre-1966 assets and the straight-line depreciation on assets acquired after 1965 (including the estimated depreciation on assets held on a rental basis during the current year) may not exceed 6 percent of the provider's allowable cost for the current year.

(b) *Definitions.*—(1) *Operating costs.* Operating costs are the total costs in-

curred by the provider in operating the institution or facility.

(2) *Allowable costs.* Allowable costs are the costs of a provider that are includable under the principles for cost reimbursement. Through application of apportionment methods to the total amount of such allowable costs, the share of a provider's total cost that is attributable to covered services for beneficiaries is determined.

(c) *Application.* If a provider has inadequate historical cost records for pre-1966 depreciable assets, the provider may elect to receive an allowance for depreciation on such assets based on a percentage of operating costs. The optional allowance for depreciation for such assets may be used, however, whether or not a provider has records of the cost of pre-1966 depreciable assets currently in use.

(d) *Allowance based on a percentage of operating costs.* (1) The allowance for depreciation based on a percentage of operating costs is to be computed by applying a specified percentage to a base amount equal to the provider's 1965 total operating costs, without adjustments to these principles or the current year's allowable operating costs, whichever is lower. The percentage to be applied is five for the reporting period that starts before or during 1966–67, four and one-half for the reporting period that begins during 1967–68, and continues to decline annually by equal amounts to become zero in 1976–77.

(2) If used as a base for determining the optional allowance for depreciation, neither the 1965 operating costs nor the current year's allowable costs are to include any actual depreciation, estimated depreciation on rented depreciable-type assets, allowance in lieu of specific recognition of other costs, or return on equity capital. Such exclusions are to be made only for the purpose of computing the allowance for depreciation based on operating costs. For other purposes, the excluded amounts are recognized in determining allowable costs and for computing the costs of services furnished to Medicare beneficiaries during the reporting period.

(e) *Change to actual depreciation.* (1) A provider that elects this allowance

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may at any time before 1976 change to actual depreciation on all pre-1966 depreciable assets. In such case, this option is eliminated and the provider can no longer elect to receive an allowance for depreciation based on a percentage of operating costs.

(2) If the provider desires to change to actual depreciation but either has no historical cost records or has incomplete records, the determination of historical cost may be made through appropriate means involving expert consultation with the determination being subject to review and approval by the contractor.

(f) *Determination of optional allowance based on percentage of operating costs illustrated.* The following illustrates how the provider would determine the optional allowance for depreciation based on operating costs.

Example No. 1. The provider keeps its records on a calendar year basis. The current year's actual allowable cost and the actual operating cost for 1965 do not include any actual depreciation or rentals on depreciable-type assets. The current year's allowable cost also does not include any allowance in lieu of specific recognition of other costs or return on equity capital.

YEAR 1966	
Current year's allowable cost	\$1,100,000
Operating cost for 1965 ¹	\$1,000,000
Percent for determining the allowance	5
Allowance	\$50,000

¹ 1965 Operating cost was used in computing the allowance for depreciation based on a percentage of operating costs because it was lower than 1966 allowable cost.

YEAR 1967	
Current year's allowable cost	\$1,200,000
Operating cost for 1965 ¹	\$1,000,000
Percent for determining the allowance ²	5
Allowance	\$50,000

¹ 1965 Operating cost was used in computing the allowance for depreciation based on a percentage of operating costs because it was lower than 1967 allowable cost.

² Since the reporting period began during the year 1966-1967 (July 1, 1966-June 30, 1967) 5 percent is the percentage to be used.

YEAR 1968	
Operating cost for 1965	\$1,000,000
Current year's allowable cost ¹	\$900,000
Percent for determining the allowance ²	4½
Allowance	\$40,500

¹ The current year's allowable cost was used in computing the allowance for depreciation based on percentage of operating costs because it was lower than 1965 operating cost.

² Since the reporting period began during the year 1967-1968 (July 1, 1967-June 30, 1968) 4½ percent is the percentage to be used.

Example No. 2. When the provider pays rent for depreciable-type assets rented prior to 1966, the estimated depreciation on such assets must be deducted from the allowance. The following illustration demonstrates how the allowance is determined.

The provider keeps its records on a calendar year basis. The current year's actual allowable cost and the actual operating cost for 1965 did not include any actual depreciation, allowance in lieu of specific recognition of other costs, or return on equity capital. However, such costs have been adjusted to exclude estimated depreciation on rented depreciable-type assets.

YEAR 1966	
Adjusted current year's allowable cost	\$1,100,000
Adjusted operating cost for 1965 ¹	\$1,000,000
Percent for determining the allowance	5
Allowance	\$50,000
Less estimated depreciation for depreciable-type assets rented prior to 1966 on which rental is paid in 1966	\$3,000
Adjusted allowance	\$47,000

¹ 1965 operating cost was used in computing the allowance for depreciation based on a percentage of operating costs because it was lower than 1966 allowable cost.

(g) *Limitation on depreciation if optional allowance is used.* This optional allowance only 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 the actual depreciation claimed, the allowance based on a percentage of operating costs, and the estimated straight-line depreciation on depreciable-type assets rented after 1965. If this sum exceeds six percent of the provider's current year's allowable cost (exclusive of any actual depreciation claimed, estimated depreciation on rented depreciable-type assets, allowance in lieu of specific recognition of other costs, and return on equity capital), the allowance for depreciation based on a percentage of operating costs is reduced by the amount of excess. In applying this limitation, if the actual depreciation claimed is on an accelerated basis, it must be converted to a straight-line basis only for use in calculating this limitation. It is presumed that pre-1966 assets will not be retired at a greater than normal rate, and the limitation of six percent,

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as it affects the availability of the allowance, is designed as a safeguard if the presumption is not borne out. If the provider does not elect to use the optional allowance, the combined allowance for depreciation based on costs of pre-1966 assets and those subsequently acquired is not subject to the six percent limitation.

Example No. 1. The following illustration demonstrates how this limitation would be determined.

YEAR 1966

[The provider keeps its records on a calendar year basis. 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
Percent for determining the allowance	5
In 1966 assets were acquired which produce a straight-line depreciation of	\$18,000
Estimated depreciation on assets rented in 1966	\$2,000
Adjusted allowable operating cost for 1966	\$1,100,000
CALCULATION OF ALLOWANCE FOR DEPRECIATION BASED ON A PERCENTAGE OF OPERATING COSTS	
Gross allowance	
5 percent times adjusted 1965 operating costs (\$1,000,000)	\$50,000
Estimated depreciation on assets rented in 1966	2,000
Straight-line depreciation on post-1965 assets	18,000
Total	70,000
6 percent of adjusted 1966 allowable operating cost	66,000
Reduction in allowance	4,000
Allowance	50,000
Reduction	4,000
Adjusted allowance	46,000
Total depreciation allowance for 1966 (\$18,000 actual depreciation plus \$46,000 allowance based on operating cost)	64,000

Assume in this illustration that the provider had elected to use the declining balance method in computing its allowable depreciation and the rental expense for depreciable-type assets was \$3,500. In that case, it would include in its 1966 allowable cost not only the \$46,000 allowance based on operating costs but also \$36,000 (in this instance 2 × straight-line rate is used) in actual depreciation and the rental expense of \$3,500—or a total of \$85,500 covering all its depreciable assets.

§ 413.144 Depreciation: Allowance for depreciation on fully depreciated or partially depreciated assets.

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

(b) *Application.* Depreciation is allowable on assets being used at the time the provider enters into the program. This applies even though such assets may be fully depreciated on the provider's books or fully depreciated with respect to other third-party payers. So long as an asset is being used, its useful life is considered not to have ended, and consequently the asset is subject to depreciation based upon a revised estimate of the asset's useful life as determined by the provider and approved by the contractor. Correction of prior years' depreciation to reflect revision of estimated useful life should be made in the first year of participation in the program unless the provider has used the optional method (§413.139), in which case the correction should be made at the time of discontinuing the use of that method. If an asset has become fully depreciated under Medicare, further depreciation is not appropriate or allowable, even though the asset may continue in use.

(c) *Example of an allowance for a fully-depreciated asset.* For example, if a 50-year-old building is in use at the time the provider enters into the program, depreciation is allowable on the building even though it has been fully depreciated on the provider's books. Assuming that a reasonable estimate of the asset's continued life is 20 years (70 years from the date of acquisition), the provider may claim depreciation over the next 20 years—if the asset is in use that long—or a total depreciation of as much as twenty-seventieths of the asset's historical cost.

(d) *Corrections to depreciation.* If the asset is disposed of before the expiration of its estimated useful life, the depreciation would be adjusted to the actual useful life. Likewise, a provider may not have fully depreciated other assets it is using and finds that it has incorrectly estimated the useful lives

of those assets. In such cases, the provider may use the corrected useful lives in determining the amount of depreciation, provided such corrections have been approved by the contractor.

§413.149 Depreciation: Allowance for depreciation on assets financed with Federal or public funds.

(a) *Principle.* Depreciation is allowed on assets financed with Hill-Burton or other Federal or public funds.

(b) *Application.* Like other assets (including other donated depreciable assets), assets financed with Hill-Burton or other Federal or public funds become a part of the provider institution's plant and equipment to be used in furnishing services. It is the function of payment of depreciation to provide funds that make it possible to maintain the assets and preserve the capital employed in the production of services. Therefore, irrespective of the source of financing of an asset, if it is used in the providing of services for beneficiaries of the program, payment for depreciation of the asset is, in fact, a cost of the production of those services. Moreover, recognition of this cost is necessary to maintain productive capacity for the future. An incentive for funding of depreciation is provided in these principles by the provision that investment income on funded depreciation is not treated as a reduction of allowable interest expense under §413.153(a).

§413.153 Interest expense.

(a)(1) *Principle.* Necessary and proper interest on both current and capital indebtedness is an allowable cost. However, interest costs are not allowable if incurred as a result of—

(i) Judicial review by a Federal court (as described in §413.64(j));

(ii) An interest assessment on a determined overpayment (as described in §405.377 of this chapter); or

(iii) Interest on funds borrowed to repay an overpayment (as described in §413.64(j) or §405.378 of this chapter), up to the amount of the overpayment, unless the provider had made a prior commitment to borrow funds for other purposes (for example, capital improvements).

(2) *Exception.* In those cases of administrative or judicial reversal, interest paid on funds borrowed to repay an overpayment is an allowable cost, in accordance with this section.

(b) *Definitions*—(1) *Interest.* Interest is the cost incurred for the use of borrowed funds. Interest on current indebtedness is the cost incurred for funds borrowed for a relatively short term. This is usually for such purposes as working capital for normal operating expenses. Interest on capital indebtedness is the cost incurred for funds borrowed for capital purposes, such as acquisition of facilities and equipment, and capital improvements. Generally, loans for capital purposes are long-term loans.

(2) *Necessary.* Necessary interest is interest that meets the following requirements:

(i) It is incurred on a loan made to satisfy a financial need of the provider. Loans that result in excess funds or investments are not considered necessary.

(ii) It is incurred on a loan made for a purpose reasonably related to patient care.

(iii) It is reduced by investment income except income from—

(A) Gifts, grants, and endowments, whether held separately or pooled with other funds;

(B) Funded depreciation that meets the program's qualifying criteria;

(C) The provider's qualified pension funds;

(D) The provider's deferred compensation funds that meet the program's qualifying criteria; and

(E) The provider's self-insurance trust funds that meet the program's qualifying criteria.

(iv) It is not reduced by interest received as a result of judicial review by a Federal court (as described in §413.64(j)).

(3) *Proper.* Proper requires that interest be—

(i) Incurred at a rate not in excess of what a prudent borrower would have had to pay in the money market existing at the time the loan was made; and

(ii) Paid to a lender not related through control or ownership, or personal relationship to the borrowing organization. However, interest is allowable if paid on loans from the provider's donor-restricted funds, the funded depreciation account, or the provider's qualified pension fund.

(4) *Zero coupon bonds.* Zero coupon bonds are issued by government agencies, corporations, and banks at a price substantially below the face value. The difference between the purchase price and the face value reflects the actual amount of interest and is neither a discount nor an adjustment to the interest rate as with other bonds. Interest is paid at maturity when the bond is redeemed at face value.

(c) *Borrower-lender relationship.* (1) Except as described in paragraph (c)(2) of this section, to be allowable, interest expense must be incurred on indebtedness established with lenders or lending organizations not related through control, ownership, or personal relationship to the borrower. Presence of any of these factors could affect the "bargaining" process that usually accompanies the making of a loan, and could thus be suggestive of an agreement on higher rates of interest or of unnecessary loans. Loans should be made under terms and conditions that a prudent borrower would make in arm'slength transactions with lending institutions. The intent of this provision is to assure that loans are legitimate and needed, and that the interest rate is reasonable. Thus, interest paid by the provider to partners, stockholders, or related organizations of the provider would not be allowable. If the owner uses his own funds in a business, it is reasonable to treat the funds as invested funds or capital, rather than borrowed funds. Therefore, if interest on loans by partners, stockholders, or related organizations is disallowed as a cost solely because of the relationship factor, the principal of such loans is treated as invested funds in the computation of the provider's equity capital under § 413.157.

(2) Exceptions to the general rule regarding interest on loans from controlled sources of funds are made in the following circumstances. Interest on loans to providers by partners, stock-

holders, or related organizations made prior to July 1, 1966, is allowable as cost, provided that the terms and conditions of payment of such loans have been maintained in effect without modification subsequent to July 1, 1966. If the general fund of a provider "borrows" from a donor-restricted fund and pays interest to the restricted fund, this interest expense is an allowable cost. The same treatment is accorded interest paid by the general fund on money "borrowed" from the funded depreciation account of the provider or from the provider's qualified pension fund. In addition, if a provider operated by members of a religious order borrows from the order, interest paid to the order is an allowable cost.

(3) If funded depreciation is used for purposes other than improvement, replacement, or expansion of facilities or equipment related to patient care, allowable interest expense is reduced to adjust for offsets not made in prior years for earnings on funded depreciation. A similar treatment is accorded deposits in the provider's qualified pension fund if such deposits are used for other than the purpose for which the fund was established.

(d) *Loans not reasonably related to patient care.* (1) The following types of loans are not considered to be for a purpose reasonably related to patient care:

(i) For loans made to finance acquisition of a facility, that portion of the cost that exceeds—

(A) Historical cost as determined under § 413.134(b); or

(B) The cost basis determined under § 413.134(g); and

(ii) Loans made to finance capital stock acquisitions, mergers, or consolidations for which revaluation of assets is not allowed under § 413.134(k).

(2) In determining whether a loan was made for the purpose of acquiring a facility, we apply any owner's investment or funds first to the tangible assets, then to the intangible assets other than goodwill, and lastly to the goodwill. If the owner's investment or funds are not sufficient to cover the cost allowed for tangible assets, we apply funds borrowed to finance the acquisition to the portion of the allowed cost of the tangible assets not covered

by the owner's investment, then to the intangible assets other than goodwill, and lastly to the goodwill. Repayments of the funds borrowed are applied first to the borrowing related to the tangible assets, then to the borrowing related to the intangible assets other than goodwill, and lastly to the borrowing related to the goodwill.

(3) When a provider borrows funds, but only some of the funds are necessary, repayments of the loan (principal and interest portions) are applied first to pay for the necessary portion of the loan. Only after all of the necessary portion of the loan (principal and interest) has been repaid are any repayments applied to the unnecessary portion of the loan. Repayments toward non-allowable borrowing pertaining to assets or activities not related to patient care are considered investments, and the provisions of paragraph (b)(2)(iii) of this section are applied.

(e) *Zero coupon bonds*—(1) *Interest on bonds issued on or after August 15, 1996.* For zero coupon bonds issued on or after August 15, 1996, interest expense incurred to provide funds for patient care-related costs is an allowable expense, and interest income earned for investment purposes is an allowable offset, in the cost reporting period in which the interest accrues.

(2) *Interest income offset.* Interest income from zero coupon bonds must be offset against allowable interest expense as prescribed in paragraph (b)(2) of this section and in §413.130(g)(2). If zero coupon bonds are purchased with the proceeds of an advanced refunding of debt, offset of the investment income is required under §413.153(b)(2)(iii), but the investment income is not prorated under §413.130(g)(2).

(3) *Use of effective interest method.* (i) Interest expense and interest income from zero coupon bonds that are reported as they accrue must be amortized using the effective interest method. This method recognizes the actual accrual of interest expense or income for each interest computation period (as specified by the bond instrument) throughout the life of the bond.

(ii) A constant effective yield rate is determined and applied to the book

value (outstanding loan balance including prior accrued interest) of the bond at the beginning of each period to determine the total interest for the period.

(iii) If the interest computation period involves portions of more than one cost reporting period, the amount of interest for that computation period shall be apportioned to each cost reporting period.

(iv) An example of the computation of interest using the effective interest method follows:

Facts

Life of zero coupon bond: 15 years.

Value at maturity: \$50,000.

Bondholder pays \$6,996 for the bond.

Annual interest rate is 13.5506% compounded semi-annually.

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

Col 1 Six-month periods	Col 2 Book value beginning of period	Col. 3 Effective interest*	Col. 4 Book value end of period (columns 2 + 3)
1	\$6,996.00	\$474.00	\$7,470.00
2	7,470.00	506.11	7,976.11
3	7,976.11	540.40	8,516.51
4	8,516.51	577.02	9,093.53
29	43,855.94	2,971.37	46,827.31
30	46,827.31	3,172.69	50,000.00

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

[51 FR 34793, Sept. 30, 1986, as amended at 56 FR 43457, Aug. 30, 1991; 59 FR 45402, Sept. 1, 1994; 61 FR 37014, July 16, 1996; 61 FR 63748, 63479, Dec. 2, 1996; 65 FR 8662, Feb. 22, 2000]

§413.157 Return on equity capital of proprietary providers.

(a) *Definitions.* For purposes of this section—

Proprietary provider means a provider that is organized and operated with the expectation of earning a profit for its owners (as distinguished from a provider that is organized and operated on a nonprofit basis). Proprietary providers may be sole proprietorships, partnerships, or corporations. Effective for cost reporting periods beginning on or after July 6, 1987, the term applies only to proprietary hospitals and SNFs.

(b) *General rule.* A reasonable return on equity capital invested and used in

the provision of patient care is paid as an allowance in addition to the reasonable cost of covered services furnished to beneficiaries by proprietary providers.

(1) *Rate of return applicable to proprietary providers for cost reporting periods beginning before July 6, 1987.* Except as provided in paragraphs (b)(2), (b)(3), and (b)(4) of this section, the amount allowable on an annual basis, for cost reporting periods beginning before July 6, 1987, is determined by multiplying the provider's equity capital by a percentage equal to one and one-half times the average of the rates of interest on special issues of public debt obligations issued for purchase by the Medicare Part A Trust Fund for each of the months during the provider's reporting period or portion thereof covered under the program.

(2) *Rate of return for inpatient hospital services furnished by proprietary hospitals.* The rate used in determining the return for inpatient hospital services is a percentage of the average of the rates of interest described in paragraph (b)(1) of this section. The percentages applicable to inpatient hospital services are as follows:

(i) 150 percent for cost reporting periods beginning before April 20, 1983.

(ii) 100 percent for cost reporting periods beginning on or after April 20, 1983 and before October 1, 1986.

(iii) 75 percent for cost reporting periods beginning on or after October 1, 1986 and before October 1, 1987.

(iv) 50 percent for cost reporting periods beginning on or after October 1, 1987 and before October 1, 1988.

(v) 25 percent for cost reporting periods beginning on or after October 1, 1988 and before October 1, 1989.

(vi) Zero percent for cost reporting periods beginning on or after October 1, 1989.

(3) *Rate of return related to proprietary SNFs.* (i) For cost reporting periods beginning on or after October 1, 1985, the rate used in determining the return for SNF services furnished before October 1, 1993, is a percentage equal to the average of the rates of interest described in paragraph (b)(1) of this section.

(ii) There is no allowance for return for SNF services furnished on or after October 1, 1993.

(4) *Rate of return related to outpatient hospital services.* (i) For cost reporting periods beginning on or after October 1, 1985, the rate used in determining the return for outpatient hospital services furnished before January 1, 1988 is a percentage equal to the average of the rates of interest described in paragraph (b)(1) of this section.

(ii) There is no allowance for return for outpatient hospital services furnished on or after January 1, 1988.

(5) *Rate of return for proprietary services of all nonhospital and non-SNF providers.* (i) For cost reporting periods beginning on or after October 1, 1985, but before July 6, 1987, the rate used in determining the return for services of all nonhospital and non-SNF providers is a percentage equal to the average of the rates of interest described in paragraph (b)(1) of this section.

(ii) For cost reporting periods beginning on or after July 6, 1987, there is no allowance for return on equity capital for nonhospital and non-SNF providers.

(c) *Application—(1) Computation of equity capital.* For purposes of computing the allowable return, the provider's equity capital means—

(i) The provider's investment in plant, property, and equipment related to patient care (net of depreciation) and funds deposited by a provider who leases plant, property, or equipment related to patient care and is required by the terms of the lease to deposit such funds (net of noncurrent debt related to such investment or deposited funds); and

(ii) Net working capital maintained for necessary and proper operation of patient care activities. However, debt representing loans from partners, stockholders, or related organizations on which interest payments would be allowable as costs but for the provisions of § 413.153(b)(3)(ii), is not subtracted in computing the amount of equity capital in order that the proceeds from such loans be treated as part of the provider's equity capital. In computing the amount of equity capital upon which a return is allowable, investment in facilities is recognized on the basis of the historical cost, or other basis, used for depreciation and other purposes under Part A of Medicare.

(2) *Acquisitions after July 1970.* With respect to a facility or any tangible assets of a facility acquired on or after August 1, 1970, the excess of the price paid for such facility or such tangible assets over the historical cost, as defined in §413.134(b), or the cost basis, as determined under §413.134(g) (whichever is appropriate), is not includable in equity capital, and loans made to finance such excess portion of the cost of such acquisitions (see §413.153(d)) are excluded in computing equity capital.

(3) *Acquisitions prior to August 1970.* With respect to a facility or any tangible assets of a facility acquired before August 1970, the excess of the price paid for such facility or assets over the fair market value of tangible assets at the time of purchase is includable in equity capital to the extent that it is reasonable except that the cumulative allowable return for such excess may not exceed 100 percent of such excess. For purposes of this section, the cumulative allowable return means the sum of the allowable rate of return on equity capital for all months starting from August 1, 1970. For example, if the allowable rates of return on equity capital for a provider are 9 percent for the first year (and such year started August 1, 1970), 8.5 percent for the second year, and 10.5 percent for the third year, the cumulative allowable return at the end of the third year would be 28 percent. After the cumulative allowable return equals 100 percent, the inclusion in equity capital of the excess is no longer allowable.

(4) *Computation of return on equity capital.* For purposes of computing the allowable return, the amount of equity capital is the average investment during the reporting period. The rate of return allowed, as derived from time to time based upon interest rates in accordance with this principle, is determined by CMS and communicated through contractors. Return on investment as an element of allowable costs is subject to apportionment in the same manner as other elements of allowable costs.

Example of calculation of cumulative allowable return. X purchased a provider on July 1, 1969, paying \$100,000 in excess of the fair market value of the assets acquired. Provider X files its cost report on a calendar-year basis.

The allowable rate of return on equity capital for August 1, 1970-December 31, 1970 (4.538 percent), is obtained by multiplying the allowable rate of return for the period ending December 31, 1970 (10.891) by $\frac{5}{12}$ (a fraction of which the numerator is the number of months from August 1, 1970, to the end of the cost-reporting period and the denominator is the number of months in the cost-reporting period). The cumulative allowable return for Provider X for the period August 1, 1970-December 31, 1973, (32.367 percent) is computed as follows:

Cost reporting year ending	Rate of return on equity capital (percent)
Dec. 31, 1970	4.538
Dec. 31, 1971	8.969
Dec. 31, 1972	8.891
Dec. 31, 1973	9.969
Total	32.367

(The \$100,000 paid in excess of the fair market value of the assets acquired is included in equity capital until the sum of the allowable rate of return on equity capital equals 100 percent. Of course, no portion of the \$100,000 may be amortized as an allowable cost or is otherwise allowable for any program reimbursement purposes other than for determining the provider's equity capital.

[51 FR 34793, Sept. 30, 1986, as amended at 52 FR 21225, June 4, 1987; 52 FR 23398, June 19, 1987; 52 FR 32921, Sept. 1, 1987; 53 FR 12017, Apr. 12, 1988; 57 FR 39830, Sept. 1, 1992; 59 FR 26960, May 25, 1994]

Subpart H—Payment for End-Stage Renal Disease (ESRD) Services

SOURCE: 62 FR 43668, Aug. 15, 1997, as amended at 86 FR 73515, Dec. 27, 2021, unless otherwise noted.

§413.170 Scope.

This subpart implements sections 1881(b)(2), (b)(4), (b)(7), and (b)(12) through (b)(14) of the Act by—

(a) Setting forth the principles and authorities under which CMS is authorized to establish a prospective payment system for outpatient maintenance dialysis services in or under the supervision of an ESRD facility that meets the conditions of coverage in part 494 of this chapter and as defined in §413.171(c).

(b) Providing procedures and criteria under which a pediatric ESRD facility