
Medicare

Provider Reimbursement Manual

Part 1, Chapter 9, Compensation of Owners

Department of Health &
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<u>HEADER SECTION NUMBERS</u>	<u>PAGES TO INSERT</u>	<u>PAGES TO DELETE</u>
900 – 907	9.3 - 9.8 (6 pp.)	9.3 - 9.8 (6 pp.)

CLARIFIED/UPDATED MATERIAL--*EFFECTIVE DATE*: Not applicable, except when specifically noted in a particular section.

Portions of the chapter were revised to update cross references and to make minor descriptive language and grammar revisions.

Section 902, Definitions, is revised to add Section 902.8 to define a proprietary provider, formerly defined in Chapter 12, Return on Equity Capital of Proprietary Providers.

Section 905.6, Inflation Factor, provides for calendar year (CY) inflation factors to update previous years' reasonable compensation ranges. The factor is from the cost category Professional Fees: Labor Related in the CMS Prospective Payment System Hospital Input Price Index. The data in the Input Price Index is taken from actual data for the most recent year from the Employment Cost Index (ECI) for Professional and Related Services published by the Bureau of Labor Statistics. The data for years prior to 2006 was from the ECI for Professional and Technical Workers. In this transmittal, the factor for CY 2010 has been added and the factor for CY 2000 has been deleted. The factors are applied on a calendar year basis.

Section 907.1, Effect on Return on Equity Capital, is deleted because the Medicare program no longer pays an allowance for a return on a proprietary provider's equity capital.

DISCLAIMER: The revision date and transmittal number apply to the red italicized material only. Any other material was previously published and remains unchanged.

900. PRINCIPLE

A reasonable allowance of compensation for services of owners is an allowable cost, provided the services are actually performed in a necessary function (*42 CFR 413.102*).

901. APPLICATION

The allowance of compensation for services of sole proprietors and partners is the reasonable value of the services *furnished*. The test of reasonableness applies to the actual compensation of all individuals performing services in connection with the operation of a provider including: (1) employees, officers, and directors owning stock in closely-held corporations; (2) employees, officers, and directors with a substantial ownership or equity in public corporations; and (3) certain employees of trusts (see § 902.6).

902. DEFINITIONS

902.1 Compensation-Sole Proprietorships and Partnerships.--The allowance of compensation for services of sole proprietors and partners is the amount determined to be the reasonable value of the services *furnished* regardless of whether there is an actual distribution of the profits of the business *or payment made to the sole proprietor/partner. (§907)*

902.2 Compensation-Corporations.--For purposes of determining whether the total compensation paid to an owner is reasonable, compensation as defined *herein* means remuneration paid to an owner regardless of the form in which it is paid. (See §§ 906 and 906.1) Compensation may be included in allowable provider cost only to the extent that it represents reasonable remuneration for managerial, administrative, professional, and other services related to the operation of the facility and *furnished* in connection with patient care. Services *furnished* in connection with patient care include both direct and indirect activities in the provision and supervision of patient care, such as administration, management, and supervision of the overall institution. *Costs of activities* not related to either direct *or* indirect patient care, e.g., those primarily for the purpose of managing or improving the owner's financial investment, are not recognized as an allowable cost. Compensation of a physician-owner of a facility is subject to an allocation between professional and provider components (see §2108 *and* §2182).

Payments found to represent a return on equity capital are not compensation and are in no event allowable as an item of reimbursable cost. Nor are such payments considered as compensation for purposes of determining the reasonable level of reimbursement of the owner.

902.3 Reasonableness.--Reasonableness requires that the compensation allowance be such an amount as would ordinarily be paid for comparable services by comparable institutions depending upon the facts and circumstances of each case. Reasonable compensation is limited to the fair market value of services rendered by the owner in connection with patient care. Fair market value is the value determined by the supply and demand factors of the open market.

902.4 Necessary.--*Necessary* means that had the owner not *furnished* the services, the institution would have had to employ another person to perform *those services*. The services must be pertinent to the sound conduct and operation of the institution.

902.5 Persons Related to Owner.--Compensation paid to an employee who is an immediate relative of the owner of the facility is also reviewable under the test of reasonableness. For this purpose, the following persons are considered immediate relatives: (1) husband and wife; (2) natural parent, child, and sibling; (3) adopted child and adoptive parent; (4) stepparent, stepchild, stepbrother, and stepsister; (5) father-in-law, mother-in-law, son-in-law, daughter-in-law, brother-in-law, and sister-in-law; (6) grandparent and grandchild.

902.6 Trusts.--Where a trust operates an institution or has an interest in the corporation or partnership operating the facility, the compensation of an employee who is the *settlor* or grantor of the trust, a trustee, or a beneficiary of the trust, is subject to the test of reasonableness.

902.7 Compensation for Persons Related to Owner.--The actual compensation to an immediate relative of an owner (as described in § 902.5) is subject to the test of reasonableness. No cost may be imputed for the value of these services.

902.8 Proprietary Provider.--*A proprietary provider is a provider organized and operated with the expectation of earning a profit for the owners (as distinguished from a provider organized and operated on a nonprofit basis).*

904. CRITERIA FOR DETERMINING REASONABLE COMPENSATION-GENERAL

In general, the determination as to the reasonableness of a person's compensation is made by comparing it with the compensation paid to other individuals in similar circumstances. To obtain uniformity in application of the principle, the contractor (1) identifies compensation paid to individuals other than owners by comparable institutions in the same geographical area, (2) furnishes this data to the CMS regional office where it is consolidated with data obtained by other contractors to produce ranges of reasonable compensation to be used in the same area, and (3) applies a set of criteria based on the qualifications and responsibilities of the owner to determine his placement within the range.

In establishing the ranges, abnormally low amounts of compensation sometimes received by employees of religiously sponsored providers may be ignored since circumstances led to the establishment of their rate of pay which are not applicable to other persons. Although contractors are to be guided by the established ranges in evaluating the reasonableness of an owner's compensation, there may be special circumstances where a contractor, on the basis of its judgment, allows an amount that is outside the established range. This might occur where the provider has certain characteristics or the owner has special qualifications and experience which would make a comparison with other institutions and individuals unrealistic.

904.1 Factors to be Considered in Determining Comparability of Institutions.--There are a number of factors involved in the determination of the comparability of institutions which include, but are not necessarily limited to, the following:

A. The Size of an Institution.--The size of institutions will generally be measured by the number of beds; however, because of differences in occupancy rates, in some situations the number of patient days for the period in question may also be used in determining whether particular providers are comparable in size. Where only a portion of the total beds of an institution are certified, the provider should be classified by the total beds available since the compensation paid administrators is based on services rendered to the entire facility. Only a portion of the allowed compensation would be allocated to the certified part of the institution. For home health agencies, size will be measured by the number of visits.

B. Classification of Institutions.--Institutions should be classified by the type and range of services offered. The type of services has reference to the nature of the services rendered; i.e., medical, surgical, rehabilitative, etc. The range of the services means the extent to which the particular kind of service can be rendered. For example, for rehabilitative services, the range of services refers to the amount and kind of physical therapy available, whether speech therapy is available, etc. In considering the type and range of services rendered, emphasis will be given to those services available in the institution rather than services which are available only when arranged for with other organizations by the provider.

C. Number and Types of Personnel Employed.--This factor refers to the number of personnel employed in the various professional and nonprofessional categories.

D. Geographical Location.--In determining the comparability of facilities, geographical location is a consideration. Since consideration is given to the area in which the institution is located and whether it is in an urban, suburban, or rural setting, differences in prevailing living and wage costs are recognized.

904.2 Factors to be Applied in Evaluating Compensation Within Range for Comparable Institutions.--The factors that are considered in determining the reasonableness of an owner's compensation within the range established for a class of institution include the following:

A. The qualifications of the owner including his educational attainment and experience in similar responsible positions. Education and experience are pertinent only as they relate to the job being performed and services being rendered. Where an owner-administrator is also a physician, the services evaluated are administrative in nature rather than the actual practice of medicine. Therefore, the compensation allowed is based on the compensation nonphysician administrators receive rather than on the rate physicians receive for their professional services.

B. The number and types of professional and other personnel supervised by the owner.

C. The duties and responsibilities of the owner and the actual services rendered.

1. Information as to the owner's actual duties, responsibilities, hours, and days regularly worked, etc., should be obtained. Compensation for "full-time" service requires that at least 40 hours per week be devoted to the duties of the position for which compensation is required. Owners devoting less than 40 hours per week to the position will be compensated on a proportionate basis, with 40 hours per week considered to be the full-time as is for such proportionate compensation.

2. The fact that an owner may have potential supervisory and managerial authority and responsibility for an institution is not as important as the manner in which authority and responsibility is actually exercised. For example, another individual, perhaps with the designation of assistant administrator, might perform most day-to-day managerial and supervisory functions in an institution. In such case, the right of the owner-administrator to overrule decisions does not constitute a basis for recognition of compensation comparable to administrators in other similar institutions.

D. Whether the owner performs services for any other institutions or is engaged in any other occupation.

1. Presumably, where an owner performs services for several institutions, he spends less than full time (i.e., at least less 40 hours a week) with each institution. In such cases, allowable compensation shall reflect an amount proportionate to a full-time basis.

2. If an owner is engaged in another activity, such as an owner-administrator also having a private medical practice, he ordinarily could not render full-time services as administrator of the institution.

905. PROCEDURES FOR DETERMINING REASONABLE COMPENSATION

905.1 General.--Contractors have the responsibility for evaluating the reasonableness of an owner's compensation in terms of the criteria provided in §§ 904.1 and 904.2. On the basis of information obtained by surveys of providers, ranges of compensation for comparable institutions will be established. Contractors will utilize these ranges both for final settlement and when setting interim rates.

Where an owner indicates he functions in an executive role other than as administrator (e.g., president, executive director, etc.), the contractor will ascertain the owner's actual duties and categorize him by the nature of the services rendered in connection with patient care rather than by the various titles administrators might have. Contractors will consolidate virtually identical or similar services to permit the establishment of realistic ranges.

Where an owner occupies a position other than as administrator (e.g., nursing supervisor), the determination of the reasonableness of the compensation may be much simpler since there would tend to be more uniformity in the type of service rendered in a position other than as an administrator.

905.2 Surveys.--Surveys shall include all proprietary institutions and a sufficient number of comparable nonproprietary institutions in the same geographical area so that an adequate comparison can be made. The comparison should take into consideration the services compensation of non-owner administrators of proprietary and nonproprietary facilities.

905.3 Uniform Approach.--The application of this policy requires a consistency in the development of ranges of compensation for services in comparable situations. To insure that this consistency is achieved, the regional offices have the responsibility for coordinating contractor activities.

There may be situations in which an individual has an ownership interest in providers serviced by different contractors. It is appropriate for contractors to inquire of the owner whether such situation does exist and, if so, to coordinate its determination with the other contractor(s).

905.4 New Providers and Future Surveys.--Where a proprietary provider first enters the program, the owner's compensation is evaluated by its contractor in terms of the ranges of compensation established for comparable institutions. After a period of time, it may be necessary for contractors to resurvey their providers because of changes in compensation levels and changes in the duties and responsibilities of the owners.

905.5 Few Similar Providers in an Area.--Where there are few comparable institutions in an area, it may be difficult for a contractor to evaluate the reasonableness of an owner's compensation. In such situations, the contractor may need to obtain information about the ranges of compensation established for comparable institutions in nearby or similar areas. Another method is to use the ranges established for another class of institution and adjust the ranges accordingly. For example, the contractor may, on the basis of its analysis and judgment, establish as reasonable compensation in a given skilled nursing facility (SNF) an appropriate proportion of the compensation paid to administrators of comparably sized hospitals in the same area. However, where this approach is taken, the fact that hospitals are generally more complex institutions than SNFs is reflected in the determination.

905.6 Inflation Factor.

Contractors apply an inflation factor to update ranges of reasonable compensation determined for previous years. The CMS furnishes an annual calendar year (CY) inflation factor for this purpose. Following are the CY factors for recent years:

2001 - 4.7%; 2002 - 3.0%; 2003 - 3.4%; 2004 - 4.3%; 2005 - 3.7%; 2006 - 3.4%; 2007 - 3.7%; 2008 - 3.0%; 2009 - 1.7%; **2010 - 1.5%**

906. TYPES OF COMPENSATION - CORPORATIONS

As indicated in §902.2, compensation for the necessary services of a stockholder-employee or an individual described in §901 (other than sole proprietors and partners) includes:

- Salary amounts paid for managerial, administrative, professional, and other services;
- Amounts paid by the institution for the personal benefit of the owner (see §906.1);
- The costs of assets and services which the owner receives from the institution (see §906.1); and
- Deferred compensation. (See §2140.)

Any payments to an owner in excess of a reasonable level do not constitute compensation or any other allowable cost.

906.1 Other Types of Compensation.--There may be instances in which an owner is receiving compensation in a form that, without close scrutiny, might not be recognized as compensation (e.g., fringe benefits). Compensation to an owner may include (1) supplies and services for the personal use of the owner, (2) special merchandise ordered from wholesalers for the owner's personal use, (3) wages of a domestic or other employee who works in the home of the owner, (4) personal use of a car owned by the business, (5) personal insurance premiums paid for the owner, and (6) other fringe benefits as described in §2144.

Any of the above payments must be included in the owner's total compensation to determine its reasonableness when such payments meet the requirements for being categorized as fringe benefits under the definition given in §2144.1. If the requirements of that section are not met, these types of payments cannot be considered compensation.

906.2 Subchapter S Corporation.--Under Federal income tax law, certain corporations can elect to be treated for tax purposes as a partnership. This election, however, has no effect on reimbursement under the Medicare program, and an owner of a Subchapter S corporation is not considered a partner for purposes of this principle.

906.3 Director Fees and Consultant Fees.--All payments by a provider to an owner which are claimed as an allowable cost are included in the owner's total compensation for purposes of determining the reasonableness of the cost claimed. This includes fees received by an owner, regardless of the label placed on them, such as consultant or director fees. The determination as to the reasonableness of such compensation is made by comparing it with amounts paid by comparable institutions for comparable services performed by their employees, rather than by considering the amounts that outside consultants receive.

906.4 Unpaid Compensation.--See §2146.2B.

General.--The compensation of stockholder-employees and individuals described in §901 (other than sole proprietors and partners) is included for a cost reporting period if earned within the period, even if not paid until after the close of the period. However, payment must be made (whether by check or other negotiable instrument, cash or legal transfer of assets such as stocks, bonds, real property, etc.) within 75 days after the close of the period. Where payment is made by check or other negotiable instrument (e.g., a promissory note), these forms of payment must be liquidated through an actual transfer of the provider's assets within 75 days after the close of the period in order to meet the requirements of this section. If payment, including the liquidation of negotiable instruments, is not made within the cost reporting period, or within 75 days thereafter, the unpaid compensation is not includable in allowable costs either in the period when earned or in the period when actually paid.

907. COMPENSATION-SOLE *PROPRIETORSHIPS* AND PARTNERSHIPS

A. General.--The allowance of compensation for sole proprietors and partners *is* the value of the services rendered by the owner. Such an amount may or may not be represented as actual payments made to the owner. There is no direct relationship between the compensation allowance of the owner and the amount of operating profit (or loss) of the facility.

In determining the allowance, the contractor *is* responding to a claim for the value of the services of the owner. That is, the institution will include in its statement of reimbursable cost an allowance for the value of the owner's services and the contractor evaluates *s* the reasonableness of this claim *by applying the criteria in this chapter.*

B. Actual Payments Made.--Where a provider has claimed as some other cost (for example, see § 906.1) an amount paid to a sole proprietor or partner, such amount is combined with the allowance claimed by the provider for the owner's services. This total is *then* used for determining the reasonableness of the compensation allowance claimed.

C. Other Considerations.--Since the compensation allowance for sole proprietors and partners is dependent upon the value of the necessary services rendered, no allowance is granted where such services are not actually rendered. This is true even if an owner is receiving payments from the provider. Therefore, although a partnership agreement might provide for retired partners to continue to receive a share of the partnership profits even though they are not rendering any services, such payments are not considered allowable costs under the program.

D. Corporation is Partner.--Where a corporation is a partner in a participating provider, the allowance of compensation for the services of stockholder employees of the corporation is limited to the actual remuneration paid. In contrast to sole proprietors and partners, these individuals do receive actual compensation for their services; separate and apart from any distribution of profits made to them by virtue of their ownership interest in the corporation. The compensation paid by the corporation *is* subject to the test of reasonableness in evaluating the partnership's claimed allowance. Further, since the corporation *is* considered related to the provider within the meaning of *Chapter 10, Cost to Related Organizations*, the provider also cannot claim amounts for services performed by other employees of the corporation which are in excess of the actual remuneration paid.