

# ***CENTERS FOR MEDICARE & MEDICAID SERVICES***

## *Decision of the Administrator*

In the case of:

**University of Pittsburgh  
Medical Center (UPMC)-  
St. Margaret Hospital**

**Provider**

**vs.**

**Blue Cross /Blue Shield Association/  
Veritus Medical Services**

**Intermediary**

Claim for:

**Provider Cost Reimbursement  
Determination for Cost Reporting  
Period Ending: 02/28/97**

**Review of:  
PRRB Decision 2006-D23  
Dated: May 26, 2006**

This case is before the Administrator, Centers for Medicare & Medicaid Services (CMS), for review of the decision of the Provider Reimbursement Review Board (Board). The review is during the 60-day period in §1878(f) (1) of the Social Security Act (Act), as amended (42 USC 1395oo (f)). The parties were notified of the Administrator's intention to review the Board's decision. Comments were received from the Center for Medicare Management (CMM) and the Intermediary requesting reversal of the Board's decision. Comments were also received from the Provider requesting affirmation of the Board's decision. All comments were timely received. Accordingly, this case is now before the Administrator for final agency review.

### **ISSUE AND BOARD'S DECISION**

The issue is whether the Intermediary's adjustments to the Medicare cost report that disallowed the loss on disposal depreciable assets due to the facility's change of ownership (CHOW) were proper.<sup>1</sup>

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<sup>1</sup> Section 4404 of the Balance Budget Act of 1997 (Pub. Law 105-33) amended §1861(v) (1) (O) (i) of the Social Security Act to terminate Medicare recognition of

The Board held that the Provider is entitled to claim a loss on disposal as a result of the statutory merger of St. Margaret Memorial Hospital (SMMH) and St. Margaret Health System (SMHS) into University of Pittsburgh Medical Center (UPMC) St. Margaret, stating that the merger resulted in a loss under 42 C.F.R. §413.134(f). The Board addressed the two fundamental arguments offered by the Intermediary in its denial of the Provider's claim. First, the Board stated that contrary to the Intermediary's arguments, the merger was not between related parties and thus, the regulation at 42 CFR 413.134(k)(2)(1) allows the assets of the merged corporations acquired by the surviving corporation to be revalued.

The Board rejected the Intermediary's assertion that the parties were related prior to the merger. The Board concluded that the plain language of the regulation barred application of the related party principle to postmerger relationships. The Board concluded that the regulation only required that the parties prior to the merger not be related. Furthermore, the Secretary's interpretive guidelines found at HCFA Pub. 134 §4502.6, which stated in part: "Medicare program policy permits a revaluation of assets affected by corporate mergers between unrelated parties" only helped to support the Board's determination.

The Board also found that because there is a specific regulation that controls the recognition of a loss on the merger transaction in this case, 42 CFR 413.134(1), the merger is not required to meet the bona fide sales transactions addressed in 42 CFR 413.134(f)(2). The Board observed that while it is aware that the regulation on mergers may be interpreted as applying to stock transactions, CMS interprets the regulation to apply to non-profit transactions as well.

The Board acknowledges that there was no "disposition" of assets as that term is used in the regulation on gains and losses and that the Providers, through merger under a new corporate structure, continued to provide substantially the same services using essentially the same facilities and personnel. However, given the regulation's explicit limitation on the application of the related party principle and CMS' longstanding interpretation that the regulation applies to non-stock company transactions, the Board found no authority in the regulation or guidelines in effect at the time of the transaction to permit motivations unique to non-profits to be a determining factor in the reimbursement treatment.

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gains and losses for depreciable assets resulting from either sale or scrapping. Conforming modifications to the applicable regulation made December 1, 1997 the effective date for implementing the new rule.

Finally, the Board found that the calculation of the loss should be based on the proportionate value method set forth in 42 CFR 413.134(f)(2)(iv). The Board stated that the manual provisions at CMS Pub. 13-4 §4506 entitled “Revaluation of Assets and Gain/Loss Computation” provide further guidelines for applying the allocation procedures for this methodology. The Board observed that the Provider submitted a calculation using this methodology and remanded this calculation to the Intermediary for review, analysis and verification before application.

## **SUMMARY OF COMMENTS**

### **Intermediary Comments**

The Intermediary submitted comments requesting that the Administrator reverse the Board’s decision. The Intermediary argued that the transaction cannot be placed under 413.134(f) as a disposal of assets which would result in a depreciation corrective adjustment since there was no “bona fide sale.” The Intermediary also disagreed with the PRRB’s observation that the concept of continuity of control has no place in the analysis of the related party element of the dispute.

### **CMM Comments**

CMM commented requesting that the Administrator reverse the Board’s decision. CMM argued that the Board made several errors in its decision. First, the Board rejected the Intermediary’s argument that there was a continuity of control that resulted in the parties to the merger being related. Under the regulation at 42 C.F.R. § 413.134(f) a provider may not claim a loss on depreciation if the sale was between related parties. Although the Board found that the language of “between two or more corporations that are unrelated” in section 413.134(k)(2)(i) pertains only to the relationship between the corporations prior to the merger, CMM believes the better reading is that the language should include the relationship between the constituent corporation(s) to a merger and the merged entity, including at the time the merger is consummated and beyond.

SMMH and its sole corporate member SMHS merged into UPMC St. Margaret, which latter corporation was created solely for the purpose of receiving SMMH and SMHS. Among other things, in this case there was a carry forward of top executives and board members pre and post affiliation that maintained the influence of the new

corporation's creators. Therefore, the Intermediary appropriately found that there was a continuity of control.

Second, the Board erred in finding that the merger was not subject to the bona fide sale requirement. There is no indication in the regulations that the bona fide sale requirement is not applicable to mergers and consolidations. In this case, the transfer of assets from the merged provider corporation was not bona fide, arms-length transaction between two non-related parties. There was never a bargaining or an attempt of maximizing fair market value of the purchase price being negotiated in an open market buyer/ seller approach. Furthermore, the consideration received as a result of the sale was less than the value of the monetary assets.

### **Provider Comments**

The Provider supported the Board's decision and pointed at several portions of the transcript as the basis for the Board's affirmation. In essence, the Provider stated that the Intermediary offered no evidence or support for its decision to deny the Provider's claim. The Intermediary's unsupported denial caused the Provider to wait over six years to have its "day in court." The Provider argued that to reverse the Board's decision would be arbitrary, capricious and an abuse of the Administrator's discretion.

## **DISCUSSION**

The entire record, which was furnished by the Board, has been examined, including all correspondence, position papers, and exhibits. The Administrator has reviewed the Board's decision. All comments received timely are included in the record and have been considered.

### **I. Medicare Law and Policy—Reasonable Costs.**

Section 1861(v)(1)(A) of the Social Security Act establishes that Medicare pays for the reasonable cost of furnishing covered services to program beneficiaries, subject to certain limitations. This section of the Act also defines reasonable cost as "the cost actually incurred, excluding there from any part of incurred cost found to be unnecessary in the efficient delivery of needed health services." The Act further authorizes the Secretary to promulgate regulations establishing the methods to be used and the items to be included in determining such costs. Consistent with the

statute, the regulation at 42 CFR §413.9 states that all payments to providers of services must be based on the reasonable cost of services covered under Medicare and related to the care of beneficiaries.

### **A. Capital Related Costs.**

Reasonable costs include capital-related costs. Consistent with the Secretary's rulemaking authority, the Secretary promulgated 42 CFR §413.130, which lists capital-related costs that are reimbursable under Medicare. Capital-related costs under Medicare include depreciation, interest, taxes, insurance, and similar expenses (defined further in 42 CFR §413.130) for plant and fixed equipment, and for movable equipment.

Title VI of the Social Security Amendments of 1983<sup>2</sup> added §1886(d) to the Act and established the prospective payment system (PPS) for reimbursement of inpatient hospital services provided to Medicare beneficiaries. Under this system, hospitals are reimbursed their inpatient operating costs on the basis of prospectively determined national and regional rates for each discharge according to a list of diagnosis-related groups. Reimbursement under the prospective payment rate is limited to inpatient operating costs. The Social Security Amendments of 1983<sup>3</sup> amended subsection (a) (4) of §1886 of the Act to add a last sentence, which specifies that the term "operating costs of inpatient hospital services", does not include "capital-related costs (as defined by the Secretary for periods before October 1, 1986)...." That provision was subsequently amended until finally, §4006(b) of OBRA 1987 revised §1886(g)(1) of the Act to require the Secretary to establish a prospective payment system for the capital-related costs of PPS hospitals for cost reporting periods beginning in fiscal year (FY) 1992.

#### **1. Depreciation.**

For cost years prior to the implementation of capital PPS, pursuant to the reasonable cost provision of §1861(v)(1)(A) of the Act, the Secretary promulgated regulations on the payment of capital costs, including depreciation. Generally, the payment of depreciation is based on the valuation of the depreciable assets used for rendering patient care as specified by the regulation. The Secretary explained, regarding the computation of gains and losses on disposal of assets, that:

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<sup>2</sup> Pub. Law 98-21.

<sup>3</sup> Section 601(a)(2) of Pub. Law 98-21.

Medicare reimburses providers for the direct and indirect costs necessary to the provision of patient care, including the cost of using assets for inpatient care. Thus, depreciation of those assets has always been an allowable cost under Medicare. The allowance is computed on the depreciable basis and estimated useful life of the assets. When an asset is disposed of, no further depreciation may be taken on it. However, if a gain or loss is realized from the disposition, reimbursement for depreciation must be adjusted so that Medicare pays the actual cost the provider incurred in using the asset for patient care.<sup>4</sup>

Basically, when there is a gain or loss, it means either that too much depreciation was recognized by the Medicare program resulting in a gain to be shared by Medicare, or insufficient depreciation was recognized by the Medicare program resulting in a loss to be shared by the Medicare program. An adjustment is made so that Medicare pays the actual cost the provider incurred in using the asset for patient care.

Although a gain or loss is recognized in the year of the disposal of the asset, the determination of Medicare's share of that gain or loss is attributable to the cost reporting periods in which the asset was used to render patient care under the Medicare program. Accordingly, although the event of the disposal of the asset may occur after the implementation of capital-PPS, a portion of the loss or gain may be attributable to cost years paid under reasonable costs and prior to the implementation of capital-PPS.

The regulation at 42 CFR §413.130 explains, inter alia, that:

- (a) *General rule.* Capital related costs...are limited to:
- (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).  
(Emphasis added.)

The regulation specifies that only certain events will result in the recognition of a gain or loss in the disposal of depreciable assets. The Secretary explained in proposed amendments to the regulation clarifying and expanding existing policy on the recognition of gains and losses, in 1976, that:

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<sup>4</sup> 44 Fed. Reg. 3980 (Jan. 19, 1979).

The revision would describe the various types of disposal recognized under the Medicare program, and would provide for the proper computation and treatment of gains and losses in determining reasonable costs.<sup>5</sup>

In adopting the final rule, the Secretary again explained that:

Existing regulations contain a requirement that any gain or loss realized on the disposal of a depreciable asset must be included in Medicare allowable costs computations ... The regulations, however, specify neither the procedures for computation of the gain or loss nor the method for making adjustments to depreciation. These amendments provide the rules for the treatment of gain or loss depending upon the manner of disposition of the assets.<sup>6</sup> (Emphasis added.)

These rules have been set forth at 42 CFR 413.134(f), which explains the specific conditions under which the disposal of depreciable assets may result in a gain or loss under the Medicare program. This section of the regulation states:

- (1) *General.* Depreciable assets may be disposed of through sale, scrapping, trade-in, exchange, demolition, abandonment, condemnation, fire, theft, or other casualty. If disposal of a depreciable asset results in a gain or loss, an adjustment is necessary in the provider's allowable cost. 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. The amount of a loss to be included is limited to the un-depreciated basis of the asset permitted under the program. 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....(Emphasis added.)

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<sup>5</sup> 41 Fed. Reg. 35197 (August 20,1976) "Principles of Reimbursement for Provider Costs: Depreciation: Allowance for the Depreciation Based on Asset Costs." (Proposed rule.)

<sup>6</sup> 44 Fed. Reg. 3980. (1979) "Principles of Reimbursement for Provider Costs." (Final rule.)

The method of disposal of assets set forth at paragraph (f) (2) through (6) is as follows. Paragraph (f) (2) addresses gain and losses realized from the bona fide sale of depreciable assets and states:

*Bona fide sale or scrapping.* (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.... (Emphasis added).

With respect to paragraph (f) (2) and the bona fide sale of a depreciable asset, Section 104.24 of the PRM states that:

A bona fide sale contemplates an arm's length transaction between a willing and well informed buyer and seller, neither being under coercion, for reasonable consideration. An arm's length transaction is ... negotiated by unrelated parties, each acting in its own self interest.<sup>7</sup>

With respect to assets sold for lump sum, paragraph (f) (2) (iv) specifies:

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 intermediary 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 sale price in accordance with the appraisal.

Paragraph (f)(3) addresses gains or losses realized from sales within 1 year after the provider terminates from the program, while §413.134(f)(4) addresses exchange trade-in or donation<sup>8</sup> of the asset stating that: “[g]ains or losses realized from the

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<sup>7</sup> Trans. No. 415 (May 2000) (clarification of existing policy).

<sup>8</sup> A donation is defined in §413.134((b)(8). An asset is considered donated when the provider acquires the assets without making payment in the form of cash, new debt, assumed debt, property or services. Section 4502.12 of the Intermediary Manual states that when a provider is donated as an ongoing facility to an unrelated party,

exchange, trade-in, or donation of depreciable assets are not included in the determination of allowable cost.” Finally, paragraph (f) (5) explains that the treatment of gains and losses when there has been an abandonment (permanent retirement) of the asset, and paragraph (f) (6) explains the treatment when there has been an involuntary conversion, such as condemnation, fire, theft or other casualty.

## 2. Revaluation of Assets.

Historically, as reflected in the regulation, the disposal of a depreciable asset used to render patient care may result in two separate and distinct reimbursement events: 1) the calculation of a gain or loss for the prior owner and 2) a revaluation of the depreciable basis for the new owner. While the determination of gains and losses is generally only of interest to the prior owner,<sup>9</sup> the new owner in the same transaction is interested in the determination of when Medicare will allow the revaluation of depreciation for purposes of calculating the new owner’s depreciation expense.

This latter issue, on the revaluation of assets, was the subject of significant litigation for the Medicare program regarding complex transaction and resulted in agency rulemaking on the subject. In response to litigation, the regulations at 42 CFR §413.134(1)<sup>10</sup> were promulgated to address longstanding Medicare policy regarding depreciable assets exchanged for capital stock, statutory mergers and consolidation. Concerning the valuation of assets, the regulation states that:

(1) *Transactions involving a provider’s capital stock—*

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(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 corporations(s) by operation of State law. The effect of a statutory merger upon Medicare reimbursement is as follow:

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there is no gain/loss allowed to the donor. The valuation of the assets to the donor depends upon use of the assets prior to the donation.

<sup>9</sup> While this is the general rule, the new owner can also have an interest in the gain or loss, when the new owner is to acquire the Medicare receivables for the terminating cost report along with the depreciable assets.

<sup>10</sup> (1995) Originally codified at 42 CFR §405.415(1).

(i) *Statutory merger between unrelated parties.* If the statutory merge 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 purchase 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.

## **B. Related Organizations**

In addition, 42 CFR 413.134 references the related organization rules at 42 CFR 413.17. The regulations at 42 CFR 413.17, states, in pertinent part:

(b) *Definitions.* (1) *Related to the provider.* Related to the provider means that the provider to a significant extent is associated or affiliated with or has control of or is controlled by the organization furnishing the services, facilities, or supplies.

(3) *Common ownership.* Common ownership exists if an individual or individuals possess significant ownership or equity in the provider and the institution or organization serving the provider.

(4) *Control.* Control exists if an individual or an organization has the power, directly or indirectly, significantly to influence or direct the actions or policies of an organization or institution.

Consistent with the Act and the regulations, the above principles are set forth in the Provider Reimbursement Manual or PRM, which provides guidelines and policies to implement Medicare regulations for determining the reasonable cost of provider services. In determining whether the parties to a transaction are related, the PRM at §1004 et. seq., establishes that the tests of common ownership and control are to be applied separately, based on the facts and circumstances in each case. With respect to common ownership, the PRM at §1004.1 states:

This rule applies whether the provider organization or supplying organization is a sole proprietorship, partnership, corporation, trust or estate, or any other form of business organization, proprietary or nonprofit. In the case of nonprofit organization, ownership or equity interest will be determined by reference to the interest in the assets of the organization (e.g., a reversionary interest provided for in the articles of incorporation of a nonprofit corporation).<sup>11</sup>

Concerning the definition of control, the PRM at §1004.3 states: “[t]he term ‘control’ includes any kind of control, whether or not it is legally enforceable and however it is exercisable or exercised.” The concept of “continuity of control” is illustrated at § 1011.4 of the PRM, in Example 2, which reads as follow:

The owners of a 200-bed hospital convert their facility to a nonprofit corporation. The owners sell the hospital to a non-profit corporation under the direction of a board of trustees made up of former owners of the proprietary corporation. Both corporations are considered related organizations; therefore, the asset bases to the nonprofit corporations remain the same as contained in the proprietary corporation’s records, and there can be no increase in the book value of such assets.

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<sup>11</sup> Trans. No. 272 (Dec. 1982)(clarifying certain ambiguous language relating to the determination of ownership or equity interest in nonprofit organizations.)

The related party organization was further explained in HCFA Ruling 80-4, which adopted the Eighth Circuit Court of Appeals' decision in Medical Center of Independence v. Harris, (CCH) Para. 30,656 (8th Cir. 1980).<sup>12</sup> The Ruling pointed out that the applicability of the related organization rule is not necessarily determined by the absence of a relationship between the parties prior to their initial contracting, although those factors are to be considered. The applicability of the rule is determined by also considering the relationship between the parties according to the rights created by their contract. The terms of the contracts and events, which occurred subsequent to the execution of the contract, in that case had the effect of placing the provider under the control of the supplier.

### **C. Non-Profit Corporations and the Related Parties and Disposal of Depreciable Asset Regulations.**

#### **1. Program Memorandum A-00-76.**

To clarify the application of 42 CFR 413.134(1) to non-profit providers with respect to the related party rules and the rules on the disposal of depreciable assets, CMS issued Program Memorandum (PM) A-00-76, dated October 19, 2000. This PM applies the foregoing regulations to the situation of non-profit corporations. In particular, this PM noted that non-profits differ in significant ways from for-profit organizations. Non-profit organizations typically do not have equity interests (i.e. shareholders, partners), exist for reasons other than to provide goods and services for a profit, and may obtain significant resources from donors who do not expect to receive monetary repayment of or return on the resources they provide. These differences, among others, cause non-profit organizations to associate or affiliate through mergers or consolidations for reasons that may differ from the traditional

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<sup>12</sup> In Medical Center of Independence, supra, the court held that a medical center and a management corporation from which it leased and operated a hospital facility were related organizations within the meaning of §413.17, where the management corporation had purchased the assets of the hospital and had entered into a 15 year lease agreement with the hospital, with a management agreement to run concurrently with the lease, and where six employees of the management corporation were elected as directors of the hospital, and two were elected as hospital officers. The court upheld the District Court's finding that the management corporation had the power, directly or indirectly, significantly to influence or direct the actions or policy of the hospital, and rejected a contention that potential influence, in the absence of a past and present exercise of influence, is insufficient to warrant a finding of control. The court stated that while the absence of any prior relationship between the parties is relevant to the issue of control, it should not automatically lead to the conclusion that the related party principle does not apply.

for-profit merger or consolidations. In contrast, the regulations at 42 CFR 413.134(1) were written to address only for-profit mergers and consolidations.

The PM also noted that, unlike for-profit mergers or consolidations, which often involve a dispatching of the former governing body and/or management team, many non-profit mergers and consolidations involve the continuation, in whole or part, of the former governing board and/or management team. Thus, in applying the related organization principles of 42 CFR 413.17, CMS stated that consideration must be given to whether the composition of the new board of directors, or other governing body and/or management team include significant representation from the previous board or management team. If that is the case, no real change of control of the assets has occurred and no gain and loss may be recognized as a result of the transaction. This PM recognized that, inter alia, certain relationships formed as a result of the merger or consolidation of two entities constituted a related party transaction for which a loss on the disposal of assets could not be recognized. The PM stressed that “between two or more corporations that are unrelated” should include the relationship between the constituent hospitals and the consolidating entity. Consequently, the PM A-00-76 states that:

whether the constituent corporations in a merger or consolidation are or are not related is irrelevant; rather the focus of the inquiry is whether significant ownership or control exists between a corporation that transfers assets and the corporation that receives them.

The PM stated that the term significant, as used in the PM has the same meaning as the term significant or significantly, in the regulations at 42 CFR 413.17 and the PRM at Chapter 10. Important considerations in this regard include that the determination of common control is subjective; each situation stands on its own merits and unique facts; a finding of common control does not require 50 percent or more representation; there is no need to look behind the numbers to see if control is actually being exercised, rather the mere potential to control is sufficient.

In addition, the PM stated that many non-profit mergers and consolidations have only the interests of the community at large to drive the transaction. This community interest does not always involve engaging in a bona fide sale or seeking fair market value of assets given. Rather, the assets and liabilities are simply combined on the merger/consolidated entities books. The merged/consolidated entity may or may not record a gain or loss resulting from such a transaction for financial reporting purposes. However, notwithstanding the treatment of the transaction for financial accounting purposes, no gain or loss may be recognized for Medicare payment purposes unless the transfer of the assets resulted from a bona fide sale as required by the regulation at 42 CFR 413.134(1) and as defined in the PRM at §104.24. The PM

stated that the regulation at 42 CFR 413.134(1) does not permit a gain or loss resulting from the combining of multiple entities' assets and liabilities without regard to whether a bona fide sale occurred. The PM stressed that a bona fide sale requires an arm's length business transaction between a willing and well-informed buyer and seller. This also requires the analysis of the comparison of the sales price with the fair market value of the assets acquired as reasonable consideration is a required element of a bona fide sale.

Notably, the Administrator finds that the requirement that the term "between related organizations" includes an examination of the relationship before and after a transaction of assets under 42 CFR 413.417 (§405.17), was applied as early as 1977 by the agency in evaluating whether accelerated depreciation would be recaptured. The agency decided that "when the termination of the provider agreement results from a transaction between related organizations and the successor provider remains in the health insurance program and its asset bases are the same as those of the terminated providers, health insurances reimbursement is equitable to all parties": thus, the depreciation recovery provisions would not be applied.<sup>13</sup> The agency looked specifically at whether, in a related party transaction, the control and extent of the financial interest remained the same for the owners of the provider before and after the termination.<sup>14</sup> Thus, the PM interpretation of the related party rules as requiring an examination of the relationship before and after the transfer of assets is consistent with early Medicare policy and HCFAR 80-4.

This interpretation, that "between related organizations" must include an examination of all parties to the transaction, both before and after, is also consistent with the reality of a transaction involving the merging of two or more entities. For example:

Corporation A and Corporation B, both non-profit providers, are combined by statutory merger with Corporation A surviving. Corporations A and B were unrelated prior to the transaction, each being controlled by its respective Board of ten Directors. After the merger, Corporation A's new ten member Board of Directors includes five individuals that served on Corporation B's pre-merger board. Thus, Corporation A's new Board of Directors includes a significant number of individual from both of the former entities' boards. Because no significant change of control of the assets of former Corporation B has occurred, the transaction as between Corporation A and Corporation

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<sup>13</sup> 42 Fed. Reg. 45897 (1977).

<sup>14</sup> 42 Fed. Reg. 45897, 45898 (September 15, 1977) (Recovery of excess cost resulting from the use of accelerated depreciation when termination of provider agreement results from transaction between related organizations.)

B is deemed to be between related parties and no gain or loss will be recognized as a result of the transaction. Hence, Medicare reasonably examines the relationship between the merging corporations and the surviving corporation and recipient of the Medicare depreciable assets to determine whether the transfer involved a related party transaction.<sup>15</sup>

## **2. The Intermediary CHOW Manual and APB No. 16.**

The Intermediary Manual, Chapter 4000, et seq., also addresses changes of ownership (CHOW) for purposes of Medicare certification and reimbursement. These sections provide guidelines based on Medicare law, regulations and implementing instructions for use by the Medicare intermediaries and providers on the reimbursement implications of various types of changes of provider organizations transactions or CHOWs. Section 4502 explains that the first review of a CHOW transaction is to determine the provider structure both before and after the transaction and to determine the type of transaction which occurred because Medicare has developed specific policies on the reimbursement effect of various types of CHOW transactions which may be different from treatment under generally accepted accounting principles or GAAP. Section 4502.1 lists the various types of provider organizational structures and included as one possible type of provider organization are Corporations.

In defining a Corporation, §4502.1 explains that a corporation is a legal entity, which enjoys the rights, privileges and responsibilities of an individual under the law. An interest in a corporation is represented by shares of stock in proprietary situations (stockholders) or membership certificates in non-stock entities (members).

Among the various types of provider structures and transactions recognized by Medicare are mergers, consolidations, and corporate reorganizations at §4502. Section 4502. 6, describes a statutory merger as the combination of two or more corporations pursuant to the laws of the state involved, with one of the corporations surviving the transaction. Medicare program policy permits a revaluation of assets acquired in a statutory merger between unrelated parties, when the surviving corporation is a provider. Notably, Medicare policy at §4502.10 does not permit a revaluation of assets affected by a “reorganization” of a corporate structure. All such transactions are considered among or between related parties. As an example the Intermediary Manual explains that:

Provider A is organized as a nonprofit corporation. The assets of Provider A are reorganized under state law into a newly created

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<sup>15</sup> Program Memorandum A-00-76 at 3.

proprietary corporation. The transaction constitutes a related party transaction (i.e., corporate reorganization). As the transaction was among related organizations no gain/loss is allowed for the seller and no revaluation is allowed for the buyer.

In the instance of a re-organization, CMS examines, inter alia, the parties before and after the transaction in determining that the transfer of assets involved a related party transaction.

Section 4508.11 of the Intermediary Manual,<sup>16</sup> in addressing stock corporations states that, Medicare program policy places reliance on GAAP, as expressed in APB No. 16 in the reevaluation of assets and gain/loss computation processes for Medicare reimbursement purposes. While in certain areas, Medicare program policy deviates from that set forth in GAAP,<sup>17</sup> Intermediaries are instructed to refer to the principles outlined in the CHOW manual which specify when reference to APB No. 16 is in accordance with the current Medicare policy.

Generally, APB No. 16 suggests two approaches to the treatment of assets when there is a business combination involving stock corporations: the pooling method and the purchase method. Historically, a combination of business interest was characterized as either a “continuation of the former ownership” or “new ownership.” A continuation of ownership was accounted for as a pooling of interest. The pooling of interest method accounts for business combinations as the uniting of the ownership interests of two or more companies. No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents and ownership interests continue. The pooling of interests method results in no revaluation of assets or recording of gains or losses. In contrast, “new ownership” is accounted for as a purchase. The purchase method accounts for a business combination as the acquisition of one company by another and is treated as purchase or sale. Thus, APB No. 16 is similar to the PM, in that both recognize and treat the pooling of interests in a business combination as an event resulting in no gain or loss, while recognizing and treating a bona fide purchase or sale in a business combination as an event resulting in a gain or loss.

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<sup>16</sup> Section 4504.1 states that: “where Medicare instructions are silent as to the valuation of consideration given in an acquisition, rely upon generally accepted accounting principles. APB No. 16 discusses valuation methods of consideration given for assets acquired in business combinations.”

<sup>17</sup> For example, Medicare will not recognize a revaluation/gain or loss due to a transfer of stock or in the case of a “two-step” transaction (i.e., the transfer of stock, than the transfer of the depreciable assets).

#### **D. Similarities of Internal Revenue Service Principles and Medicare Reimbursement Principles When Entities Consolidate or Merge.**

This policy of not recognizing a gain or loss when the transaction is between related parties, whether it constitutes a reorganization, consolidation or merger, is also consistent with Internal Revenue Service (IRS) rules on the non-recognition of a gain or loss when a statutory reorganization has been determined to have occurred. Relevant to this case, while the Medicare rules may diverge from IRS rules and Medicare policy is not bound by IRS policy, IRS policy often reflects rationale underlying the establishment of similar policies under Medicare.<sup>18</sup> In fact, in setting forth principles applicable to the recognition of the gain or a loss, CMS has in the past recognized the similarity of the Medicare principles and the IRS principles and has often explicitly stated when such Medicare policy agrees or diverges from IRS treatment.<sup>19</sup>

Under IRS rules, some mergers are considered statutory reorganizations and subject to the non-recognition of a gain or loss. The terms reorganization and merger are not mutually exclusive terms under IRS rules. Medicare policy similarly indicates that they are not mutually exclusive terms under Medicare rules. That is, consolidations and mergers may in fact constitute in essence, reorganizations and reorganizations may involve more than one corporation.<sup>20</sup> For example, a merger where the predecessor corporation board continues significant control in the new corporation board is treated the same as reorganization for Medicare reimbursement purposes and no gain or loss is recognized. However, for example, where the predecessor corporation board does not continue significant control in the new corporation board, a gain or loss will be recognized for Medicare reimbursement purposes.

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<sup>18</sup> See, e. g., Guernsey v. Shalala, 115 S. Ct. 1232 (1995), analogizing Medicare rules to IRS rules in citing to Thor Power Tools v. Commissioner, 439 U.S. 522 (1979).

<sup>19</sup> See, e.g., 44 Fed. Reg. 3980 (January 19, 1979) ( “If a provider trades in or exchanges an asset, no gain or loss is included in the computation of allowable cost. Instead, consistent with the Internal Revenue Service (IRS), the un-depreciated value of the traded asset, plus any additional assets transferred to acquire the new assets, are used as the basis for depreciation of the new asset under Medicare”; 48 Fed. Reg. 37408 (Aug. 18. 1983) (finding that it was not appropriate for the Medicare program to use IRS accelerated costs recovery system for Medicare purposes and deleting IRS useful life guidelines).

<sup>20</sup> See Black’s Law Dictionary (7th Ed. 1999), definition of a reorganization used interchangeably with merger and consolidation ( “A reorganization that involves a merger or consolidation under a specific State statute.”)

Similar to Medicare rules, the IRS does not allow the recognition of the gain or loss when there is a reorganization, inter alia, because no gain or loss has in fact been realized. As the courts have noted:

The principle under which statutory reorganizations are not considered taxable events is that no substantial change has been affected either in the nature or the substance of the taxpayer's capital position, and no capital gain or loss has actually been realized. Such a reorganization contemplates a continuity of business enterprise and a continuity of interest and control accomplished [in this instance] by an exchange of stock for stock.<sup>21</sup> (Emphasis added.)

Similarly, the courts have stated that the underlying purpose of the IRS provisions that find no gain or loss when there is a reorganization was twofold: “1) to relieve certain types of corporate reorganizations from taxation which seemed oppressively premature and 2) to prevent taxpayer's from taking losses on account of wash sales and other fictitious exchanges.”<sup>22</sup> Finally, as the Supreme Court found in Groman v. Commissioners, 302 U.S. 82, 87 (1937) certain transactions speak for themselves, regardless of how they might be cast. As the Supreme Court observed: “If corporate A and B transfer assets to C, a new corporation, in exchange for all of C's stock, the stock received is not a basis for calculation of a gain on the exchange ... A and B are so evidently parties to the reorganization that we do not need [the IRS code] to inform us of the fact.” In sum, the purpose of these provisions is “to free from the imposition of an income tax purely ‘paper profits or losses’ wherein there is no realization of gain or loss in the business sense but merely the recasting of the same interests in a different form.”<sup>23</sup>

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<sup>21</sup> Commissioners of IRS v. Webster Estates, 131 F. 2d 426, 429 (2d Cir.1942) citing Helvering v. Schoellkopf, 100 F. 2d 415 (2d Cir) While the foregoing IRS cases illustrate the continuity of interest, the Administrator notes that the Medicare program does not recognize a loss on sale as a result of a stock transfer regardless of the relationship between the parties. Case law also shows that term “continuity of interest” as provided in the IRS regulation is at times used interchangeably with the term “continuity of control.” See e.g. New Jersey Mortgage and Title Co. v. Commissioner of the IRS, 3 T. C. 1277 (1944); Detroit-Michigan Stove Company v. U.S., 128 Ct. Cl. 585 (1954).

<sup>22</sup> C.H. Mead Coal Co. v. Commissioners of IRS, 72 F. 2d 22, 27-28 (4th Cir. 1934) (analyzing early sections of the code.)

<sup>23</sup> Paulsen ET UX v. Commissioner, 469 U.S. 131 (1985) citing Southwest Natural Gas Co. v. Commissioner, 189 F. 2d 332, 334 (CA 5), cert. denied, 342 U.S. 860 (1951) (quoting Commissioner v. Gilmore's Estate, 130 F. 2d 791, 794 (CA 3 1942)).

The IRS rules also deny gains or losses from the sale or exchange of property between related parties. In explaining the rationale for this tax law provision, the court in Unionbancal Corporation v. Commissioner, 305 F. 2d 976 (2001), explained that:

This limitation on deductions for transfers between related parties, protects the fisc against sham transactions and manipulations without economic substance. Not infrequently though, there are honest and important non-tax reasons for sales between related parties, so it's important to fairness to preserve the pre-sale basis where loss on the sale itself isn't recognized for tax purposes. Otherwise the statute would be a heads-I-win, tails-you-lose provision for the IRS: the seller can't take the loss, but the IRS calculates the buyer's gain on resale using the lower basis.

Consequently, one purpose of the IRS policy is to prevent the claiming of a gain or loss when no such event has in fact occurred. Similarly, the related party rules under Medicare, in holding that there is no recognition of a gain or loss when there is a reorganization, consolidation or merger between related parties, is to avoid the payment of costs not actually incurred by the parties. An overarching principle applicable under the Medicare statute and regulation, with which all reasonable cost regulations must be in accord, is the principle that Medicare will only share in costs actually incurred by the provider. Consistent with IRS rules, which recognize that no cost has been incurred under the foregoing facts, Medicare similarly does not find that the provider has incurred an actual cost for purposes of Medicare reimbursement under such facts.

## II. Finding of Facts and Conclusion of Law.

This particular case involves the Provider's claim for a loss on the disposal of assets as a result of a merger. The transaction involved the St. Margaret Memorial Hospital (SMMH) (the Provider), its corporate member St. Margaret Health Systems, Inc. (SMHS) and the University of Pittsburgh Medical Center System (UPMCS).

SMMH (the Provider) was a Pennsylvania nonprofit corporation and a duly licensed general hospital located in Pennsylvania. Its sole corporate member was SMHS. UPMCS was a Pennsylvania nonprofit corporation located in Pittsburgh, Pennsylvania and the parent and corporate member of a major academic center and integrated health care system.

On November 4, 1996, officers of SMMH, SMHS and UPMCS co-signed a letter described in its paragraph 16 as a non-binding Letter of Intent which outlined a process of proposed integration of SMMH with the UPMCS system.<sup>24</sup> On January 10, 1997, a Pennsylvania nonprofit corporation named University of Pittsburgh Medical Center, St. Margaret (UPMC St. Margaret) was incorporated, but it was not operational until March 1, 1997.<sup>25</sup> UPMCS was the sole corporate member of UPMC St. Margaret. The incorporator of UPMC St. Margaret was an officer of SMMH.

On February 3 1997, UPMCS, SMMH and SMHS executed the merger and affiliation agreement with the merger to be effective no later than March 1, 1997.<sup>26</sup> Concurrent with the closing, SMHS and SMMH were to be merged into and with UPMC St. Margaret in a statutory merger. UPMC St. Margaret was the surviving corporation. The merger agreement described UPMC St. Margaret as the new corporation into which St. Margaret and SMHS would be merged. Following the closing, the separate corporate existence of SMHS and SMMH ceased. UPMC St. Margaret continued as the surviving corporation and succeeded to and assume all the rights and obligations of SMHS and SMMH.<sup>27</sup>

In finding that the above transaction required the recognition of a loss on the disposal of assets, the Board made several findings regarding the interaction of the various regulations on 42 CFR 413.134(l).<sup>28</sup> The Board held that the general rules on the

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<sup>24</sup> Intermediary I-22. See also June 3, 2005 Joint stipulations.

<sup>25</sup> Provider P-5. See also June 3, 2005 Joint stipulations

<sup>26</sup> Intermediary Exhibit I-8. See also June 3, 2005 Joint stipulations.

<sup>27</sup> Intermediary Exhibit I-8. See also June 3, 2005 Joint stipulations.

<sup>28</sup> See *supra*, redesignated at 42 C.F.R 413.134(k)(2002).

disposal of assets and related parties were not controlling over the specific language of paragraph (l) regarding merger. While the general related party rules could be interpreted to require an examination of the relationship between the merging entities, the Board found that this interpretation was rejected by the Secretary.

However, the Administrator finds that, as the issue under appeal involves the recognition of depreciation lost on the transfer of assets from a merger between nonprofit entities, he cannot limit his review to 42 CFR 412.134( l). Paragraph ( l) was drafted specifically to address the revaluation of assets for proprietary corporations that merge or consolidate, while paragraph (f) specifically addresses circumstances under which a gain or loss will be recognized. Paragraph ( l) did not address or modify the criteria for the recognition of gains or losses at paragraph 42 CFR 413.134(f). Instead, the Secretary explicitly stated that this provision was being promulgated consistent with both the related party rules and the disposal of depreciable asset rules set forth at paragraph (f) and thus must be interpreted consistent with those provisions.<sup>29</sup>

Applying the statute, regulations, PRM and CMS policy to the facts of this case, the Administrator finds that based on a combination of factors the parties to the transaction (i.e., merger) are related through control. In applying the related party principles at 42 CFR 413.17, the Administrator finds that consideration must be given as to whether the composition of the new board of directors at the surviving corporation included significant representation from the SMMH and SMHI board or

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<sup>29</sup> See e.g., 44 Fed. Reg. 6912 (Feb 5, 1979) ( “Although no single provision of the Medicare regulations explicitly set forth these policies, our position has been based on the interaction of three regulations: 42 CFR 405.415, concerning the allowance for depreciation based on asset costs; 42 CFR 405.427, concerning cost related organizations; and 42 CFR 405.626, concerning change of ownership. We continue to believe that our interpretation and application of these regulations are reasonable and consistent with our statutory mandate to determine the scope of the reasonable costs for Medicare providers.” (Emphasis added.)); 42 Fed. Reg. 6912 (“Our intent is not to change existing Medicare policy, but merely to state explicitly in the Code of Federal Regulations that which has been stated in the past in less formal settings.”); 42 Fed. Reg. 17486 (1977) (“The proposed revision of paragraph (l) of 405.415 is also consistent with paragraph (f). When a provider’s assets are sold the transaction causes adjustments to the seller’s health insurance program allowance for the depreciation based upon the gain or loss on the sale of the asset. Because a sale of corporate stock is not a sale of the corporate assets, the provisions of paragraph (f) of 405.415 are not applicable to the seller after such a transaction.”); 44 Fed. Reg. 6913 (“Only if the assets are transferred by means of a bona fide transaction between unrelated parties would revaluation be proper.”)

management team and whether there continued significant representation of the Provider's management team on the surviving corporation. This consideration involves determining whether former board members of the SMMH and SMHI had the power, to directly or indirectly, to significantly influence or direct the actions or policies of the surviving corporation. If such is the case, then no real change of control of the assets has occurred and no gain or loss will be recognized as a result of this transaction. As stated above, the term "control" includes any kind of control, whether or not it is legally enforceable and however it is exercisable or exercised.

The Administrator finds that there was a continuity of control that resulted in the parties to the merger being related. Prior to the merger there was evidence that SMHS/SMMH was related to the surviving corporation UPMC St. Margaret since the sole person that incorporated the surviving corporation was an officer of SMMH. In addition, SMMH's board had consisted of 12 members. After the merger, UPMC St. Margaret Hospital's board consisted of 8 out of the original 12 members of SMMH and SMHS plus 6 new members representing UPMCS.<sup>30</sup> Pursuant to the MA, the new structure of the governing board would consist of a total 16 members, ten from the SMMH and SMHS board and six from UPMCS.<sup>31</sup> The representation of significant number of the Provider's former board members on the board of the surviving corporation shows that the Provider continued to be able to exert influence and control in the surviving corporation and over the transferred assets. Notably, the only entities with assets that merged into UPMC St. Margaret was SMMH/SMHS and it is those assets SMMH/SMHS continued to control as shown in its former board members significant and continuing representation on the surviving corporation's board. In addition, the merger agreement called for a five-year transition period during which time SMMH/SMHS retained significant powers on the board of directors of UPMC St. Margaret.

The record also shows that a significant number of high level executives/officers of SMMH/SMHI were similarly positioned in the surviving entity.<sup>32</sup> The record shows that the President, three Vice Presidents and the Controller of SMMH remained in these same positions in the surviving corporation.<sup>33</sup> All of the foregoing demonstrates that there was a continuity of control in the surviving corporation by

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<sup>30</sup> Intermediary's Exhibit I-7. See also June 3, 2005 joint stipulations (list seven common board members but omits one ex-officier with vote which totals eight.)

<sup>31</sup> Each entity, UPMCS and SMMH/SMHI, had the option of appointing less than 6 and 10 members, respectively, hence, the 14 member board for UPMC St. Margaret.

<sup>32</sup> See Intermediary Exhibit I-7.

<sup>33</sup> See Intermediary Exhibit I-7.

former members of the SMMH and SMHS board and officers over the transferred assets after the merger with UPMC St. Margaret.

The Administrator also finds that the Provider is not entitled to a loss on the disposal of assets because the Provider failed to show that there was a *bona fide* sale of its depreciable assets. As stated above a *bona fide* sale contemplates an arm's length transaction, between unrelated parties for reasonable consideration, with each party acting in its own self interest. As outlined in PM A-00-76, in evaluating whether a *bona fide* sale has occurred with respect to a merger or consolidation between or among nonprofit entities, a comparison of the sale price with the fair market value of the assets acquired is required. A large disparity between the sale price (consideration) and the fair market value of the assets sold indicates the lack of a *bona fide* sale.

In this case, the record shows that the Provider transferred a combination of cash and current assets with a book value of approximately \$86 million and depreciable assets with a net book value of approximately \$49 million (for a total of approximately \$136 million) in exchanged for approximately \$71 million.<sup>34</sup> Even if the value of the depreciable assets are not considered, UPMC St Margaret's assumption of the Provider's debt ("purchase price") was \$15 million less than the Provider's current and monetary assets alone. This purchase price cannot be considered reasonable consideration and, thus, the transaction did not constitute a *bona fide* sale.

The fact that the Provider did not secure an appraisal prior to closing date of this transaction is a further indication that the Provider was not concerned with receiving reasonable consideration for its depreciable assets. Further, there is no documentation as to the basis for the Provider's conclusion that the assumption of debt was fair consideration for the Provider's assets. Thus, the Administrator finds that, that the transaction was not a *bona fide* sale as required under the regulations and PRM for the recognition of a loss on the disposal of assets.

Finally, as a loss cannot be allowed in this case, the Administrator does not reach the issue of how to calculate the loss.

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<sup>34</sup> Provider's Exhibit 10. As the surviving entity apparently assumed the Provider's Medicare accounts, the result of any successful Provider appeal would also increase the current and monetary assets obtained by the surviving corporation in this transaction.

**DECISION**

The decision of the Board is reversed in accordance with the foregoing opinion.

THIS CONSTITUTES THE FINAL ADMINISTRATIVE DECISION OF  
THE SECRETARY OF HEALTH AND HUMAN SERVICES

Date: 7/25/06

/s/  
Leslie V. Norwalk, Esq.  
Deputy Administrator  
Centers for Medicare & Medicaid Services