

PROVIDER REIMBURSEMENT REVIEW BOARD HEARING DECISION

98-D59

PROVIDER -Hospital San Francisco,
Inc.
Rio Piedras, Puerto Rico

DATE OF HEARING-
November 6, 1997

Provider No. 40-0098

Cost Reporting Period Ended -
December 31, 1989

vs.

INTERMEDIARY -
Cooperativa De Seguros De Vida
De Puerto Rico

CASE NO. 93-1280

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ISSUE:

Was the Intermediary's disallowance of the Provider's request for a reevaluation of assets and allowance of interest expense due to a change in ownership proper?

STATEMENT OF THE CASE AND PROCEDURAL HISTORY:

Hospital San Francisco Inc. ("Provider") a corporation duly registered under the Laws of the Commonwealth of Puerto Rico, is an acute care general hospital located in Rio Piedras, Puerto Rico. On December 23, 1987, the Provider purchased for the amount of \$5,300,000 substantially all of the assets of Hospital Monteflores, Inc. d/b/a Hospital San Martin ("San Martin") from the stockholders of San Martin. The Provider was certified as a Medicare participant as of December 23, 1987.

The stockholders of San Martin received almost all of the assets of San Martin as a liquidating dividend in exchange for the shares they held in the corporation. Major stockholders received assets as liquidating dividends from San Martin as part of the liquidation plan.¹ Other assets, stocks, accounts payable, etc were retained by San Martin. None of the stockholders who acquired the assets were Medicare participants.

After being certified as a participating provider, an audit was conducted for the year ended December 31, 1989, resulting in a disallowance of depreciation related to the reevaluation of assets, interest expense on investment income and working capital, and the amortization of deferred cost resulting from the purchase of assets from San Martin.

San Martin was a for profit corporation that participated in the Medicare program. The stock of San Martin was held by six individuals and two estates. All but one of the shareholders were related. Prior to December 23, 1987, San Martin acquired 1,191 shares (out of 4230) from the minority stockholders in exchange for cash. The remaining stockholders received a liquidating dividend on December 23, 1987, in which the corporation exchanged all outstanding stock for the net assets of the corporation. On the same day, December 23, 1987, the stockholders sold the assets received, except for the accounts receivable, to the Provider. Corporate liability was retained by the selling group.

The Provider in its December 31, 1989 cost report claimed the step-up basis of the assets it acquired. In order to purchase the assets from the stockholders the Provider obtained a loan, in the amount of \$6,000,000, from an unrelated source. The Provider claimed the interest expense related to the asset acquisition financing as capital related interest. The Intermediary issued a NPR and disallowed the reimbursement effect of the revaluation of assets and the related interest expense as well as the amortization of the deferred costs that resulted from the purchase of the assets. The Provider disagreed with the Intermediary's adjustments and filed

¹ Tr. at 6.

a timely appeal with the Provider Reimbursement Review Board (“Board”) pursuant to 42 C.F.R. §§ 405.1835-.1841 and has met the jurisdictional requirements of those regulations. The Medicare reimbursement effect is approximately \$97,503.

The Provider was represented by Ivelisse Torres, Esquire. The Intermediary was represented by Wallace Vasquez Sanabria, Esq. of Cooperativa de Seguros de Vida de Puerto Rico.

PROVIDER’S CONTENTIONS:

The Provider contends that the Board has jurisdiction over the December 31, 1989 cost report appeal. The Provider properly appealed the decision of the Intermediary within the 180 day limitation for requesting an appeal.

The Provider points out that § 2314 of the Deficit Reduction Act (DEFRA) adds new provisions concerning the valuation of assets, and determining historical costs of assets after July 18, 1984. In regard to a change of ownership (“CHOW”), the value of an asset to a new owner after a CHOW is the lesser of the allowable acquisition cost or the book value of the previous owner. In a case where an asset is not in existence prior to July 18, 1984, the value of the asset is the acquisition cost of the asset to the new owner.

The Provider contends that since the former stockholders of San Martin owned the assets, which they acquired as a liquidating dividend, and sold them to the Provider in an arms length transaction, the value of the assets under DEFRA should be the sale price, which was \$5,300,000. The Provider points out that an appraisal was used to allocate the purchase price among the assets purchased. The transaction was registered in the Property Registry, in accordance with the Mortgage Law of Puerto Rico and executed before a Notary Public. The Provider points out that if San Martin had sold the assets directly to the Provider, then, under DEFRA the value of the assets would be their book value in the hands of San Martin. However, since the assets were owned by the stockholders, and not the former owner, San Martin, the value of the assets should be the amount of the purchase price. The Provider argues that the Intermediary was not correct when it disallowed the reevaluation of the assets on the grounds that assets cannot be revalued when a CHOW occurs either by asset acquisition or 100% stock acquisition.

The Provider points out that the Medicare Intermediary Manual (“HCFA Pub. 15-3”) indicates the method to be used in reevaluating assets. The Provider asserts that when a Change Of Ownership (CHOW) results in a gain or loss to the seller, acquisition costs are reviewed and a reevaluation of assets may be permitted for the buyer. If no CHOW is recognized for reimbursement purposes, no gain or loss to the seller is computed, and no revaluation of assets is permitted for the buyer. The Intermediary in the case at bar did recoup depreciation expense and interest in the amount of \$574,171, which the Provider contends proves that the Intermediary recognized a CHOW. However, the Intermediary never allowed a reevaluation of the assets.

The Provider contends that it incurred certain acquisition costs such as legal fees, commissions, stamps, origination fees, pre-opening, surveying, and appraisal costs. They argue that since they are the first owner of record, the acquisition costs are reimbursable by the Medicare program. These expenses were not paid by the former owner and, therefore, the Provider is entitled to claim the acquisition costs.

The Provider points out that it paid \$5,300,000 for the assets plus \$565,077 in acquisition costs for a total of \$5,865,077. These expenditures were financed by a loan of \$6,000,000. The Provider also points out that the stockholders made an initial capital contribution of \$1,000,000 which was needed for working capital to finance the day to day operation and improvements of patient care facilities. The Provider argues that it was not proper for the Intermediary to offset the initial capital contribution against the total debt, since the financing needs were necessary and much higher than the total debt.

The Provider further contends that the Intermediary considered the historical cost of San Martin instead of the incurred costs of the Provider. The Provider argues that pursuant to 42 C.F.R.

§ 413.153, interest expense is an allowable cost to the extent that it is “necessary and proper.” “Necessary” means that the interest expense relates to a patient-related asset or was required to obtain patient capital, and that all the Provider’s available funds were expended before or concurrent with incurring the debt. It is also defined as requiring the offset of investment income against allowable interest expense” which is not the case here. “Proper” means that the interest is incurred on a debt established with an unrelated party and the rate of interest is fair market value.

The Provider points out that interest expense can be either a capital related expense or an operating expense. Interest on debts incurred to acquire depreciable assets is capital related interest, and interest for working capital is operating interest expense.

The Provider argues that pursuant to Medicare regulations, a provider must include in its capital related cost, interest expense, if such expense is incurred on:

- 1) acquiring land and/or depreciable assets, (either through purchase or lease) used for patient care
- 2) refinancing existing debt, if the original purpose of the refinanced debt was to acquire land and/or depreciable assets used for patient care.

42 C.F.R. § 413.130(f)(i)(ii).

Therefore, the Provider points out it is entitled to interest expense, amortization expense and depreciation expense.

INTERMEDIARY'S CONTENTIONS:

The Intermediary points out that the Provider entered into the purchase agreement on December 23, 1987, which is clearly after the enactment of Public Law 98-369 (DEFRA) which amended Section 1861(v)(1) of the Social Security Act. The Provider points out that section 2314 of DEFRA states in part:

[w]here an asset of a hospital or SNF undergoes a CHOW on or after July 18, 1984, the valuation of the asset after the CHOW is limited to the lesser of the allowable acquisition cost of the asset to the owner of record as of July 18, 1984, or the acquisition cost to the new owner.

Id.

The Intermediary, therefore, based on the above cited regulation, asserts that the Medicare program will no longer allow step-up in excess of the historical cost basis on acquired depreciable assets. The Provider is therefore required to use the book value of the assets purchased rather than the amount paid for the assets.

The Intermediary points out that the Medicare regulation at 42 C.F.R. § 413.134(b) states in part:

(ii) Hospitals and SNFs only. (A) For assets acquired on or after July 18, 1984 and not subject to an enforceable agreement entered into before that date, 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.

Id.

The Intermediary is not in agreement with the Provider's contention that the following cases are applicable to the case at bar: Humana Inc. v. Heckler, 758 F.2d 696 (D.C. Cir 1985), and Pia Asheville v. Bowen, 850 F.2d 739 (D.D.C. 1987). Those cases are not applicable to the current case because the transfer of assets in both cases occurred prior to July 18, 1984, the effective date of DEFRA. The Intermediary also disagrees with the Provider's contention that Bellaire General Hospital v. Mutual of Omaha, PRRB Dec. No. 92-D8, February 7, 1992

(“Bellaire”) Medicare and Medicaid Guide (CCH) ¶ 40,037 is applicable to the current case. The Intermediary argues that case is distinguishable from the facts in this case because Bellaire was not a Medicare provider as of July 18, 1984.

The Intermediary argues that § 4507 of HCFA Pub.13-4 requires a buyer to deduct from the allowable cost of assets the equity investment and allocate these between tangible and intangible assets related to patient care. Those not related to patient care and goodwill and interest expense are to be allocated on that same base. The Manual section states as follows:

[t]o determine the amount of debt that can be allocated for Medicare purposes, HCFA Pub. 15-1 § 203 requires that the buyer’s equity investment be subtracted from the allowable cost of the assets related to patient care. The resulting amount represents the maximum amount of debt that can be allocated to the acquired assets on which interest is allowable.

Id.

The Intermediary also points out that it made the required adjustments but erred in the calculation. The adjustment should have been \$229,205 and not \$118,000. Applying the Medicare utilization of 30% results in a Medicare adjustment of \$80,950 instead of \$47,950.

The Intermediary further argues that the organization costs incurred by the Provider are not an allowable Medicare cost.

Finally, the Intermediary contends that the Board does not have jurisdiction in this case. The issue was originally reviewed by the Intermediary as a result of an audit for the fiscal year ended December 31, 1988. In as much as the issue was not appealed for that year, and 180 days have elapsed the Provider is time bared from raising the instant appeal.

CITATIONS OF LAWS, REGULATIONS AND PROGRAM INSTRUCTIONS:

1. Laws - 42 U.S.C.:

§1395x(v)(1)(A)	-	Reasonable Cost
§ 1861(v)(1)	-	Reasonable Cost
§ 2314 Public Law 98-369	-	Deficit Reduction Act of 1984

2. Regulations - 42 C.F.R.:

§ 413.130	-	Capital Related Costs
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- § 413.134 - Depreciation: Allowance for Depreciation Based on Asset Costs
- § 413.153 - Interest Expense
- 3. Program Instructions - Provider Reimbursement Manual Part I (HCFA Pub. 15-1):
 - § 2304 - Adequacy of Cost Information
 - § 2920 - Right to Board Hearing
- 4. Program Instructions - Part A, Intermediary Manual (HCFA Pub. 13-4):
 - § 4507 - Allocation of Debt and Interest
 - § 4508.2A - Acquisition Costs
- 5. Cases:
 - Humana Inc. v. Heckler, 758 F.2d 696 (D.C.Cir 1985).
 - Pia Asheville v. Bowen, 850 F.2d 739 (D.D.C. 1987).
 - Bellaire General Hospital v. Mutual of Omaha, PRRB Dec. No. 92-D8, February 7, 1992, Medicare and Medicaid Guide (CCH) ¶ 40,037.

FINDINGS OF FACT, CONCLUSIONS OF LAW AND DISCUSSION:

The Board, after consideration of the facts, parties' contentions, evidence presented, testimony given at the hearing, and post hearing brief, finds and concludes that there are actually four issues to be adjudicated. The issues are:

1. Does the Board have jurisdiction in this case?
2. Is the basis of the assets acquired from the former stockholders of San Martin the basis for valuation of the Provider's assets?
3. Is the amount of interest allowable limited to the basis of the assets acquired?
4. Is the amount of organization cost claimed by the Provider allowable?

Issue 1 - Jurisdiction:

The Board finds that the Provider responded to the Intermediary's NPR within the required 180 day limitation. The Board finds that the Intermediary's contention that the issue is time barred because the same adjustment was made to the 1988 cost report, and since that NPR was not appealed, the 1989 cost report adjustment cannot be appealed either, is without merit. The Board finds that the Provider is entitled to a Board hearing pursuant to the Medicare regulation at 42 C.F.R. § 405.1835 which states in part:

The provider. . . has a right to a hearing before the Board about any matter designated in § 405.1801(a)(1), if:

- (1) An intermediary determination has been made with respect to the provider; and
- (2) the provider has filed a written request for a hearing before the Board under the provisions described in 42 C.F.R. § 1841(a)(1);

Id.

The Board concludes that every Notice of Program Reimbursement constitutes a separate and distinct determination to which provisions of the right to a Board hearing are applicable. Therefore the Provider is entitled to a Board hearing.

Issue 2 - Basis of Assets:

The Board finds that the Provider is not entitled to use the stepped-up purchase price of \$5,300,000 in determining the depreciable basis of the facility for Medicare reimbursement purposes. The Board finds that the Provider was certified to participate in the Medicare program effective December 23, 1987. This was after the enactment of Section 2314 of DEFRA, which was effective July 18, 1984. The Board finds that the Provider purchased the assets from a group of stockholders who obtained the assets as a liquidating dividend from the former Provider. The liquidating dividend was issued to the stockholders on the same day that they sold the assets to the Provider. The Board finds that these simultaneous transactions appear to be an attempt to circumvent section 2314 of DEFRA.

The Board points out that Section 2314 of DEFRA (Public law 98-369) amended section 1861(v)(1) of the Social Security Act by adding the following provision:

Where an asset of a hospital or SNF undergoes a CHOW on or after July 18, 1984, the valuation of the asset after the CHOW is limited to the lesser of the allowable acquisition cost of the asset to the owner of record as of July 18,

1984, or the acquisition cost to the new owner. . . . The above provisions do not apply to a CHOW of assets pursuant to an enforceable agreement entered into before July 18, 1984.

Id.

Since the transaction at issue was completed on December 23, 1987, which was after the enactment of DEFRA, the DEFRA regulation is applicable to this situation.

The Board notes that San Martin never closed its doors. The new Provider took over the operation on the same day that it was transferred to the stockholders. The stockholders made no attempt to establish themselves as a non-Medicare entity through such mechanisms as leasing the assets to the Provider.

Issue 3 - Interest:

The Board finds that interest expense must be allocated in accordance with § 4507.2 of HCFA Pub. 13-4 which states in part:

1. After subtracting the buyer's investment, HCFA Pub. 15-1, § 203 requires the debt to be applied in the following sequence to the assets acquired:
 - Tangible assets related to patient care,
 - Intangible assets related to patient care,
 - Tangible and intangible assets not related to patient care and goodwill

The Board also finds that the interest expense incurred to borrow working capital is not a capital related expense, although it may be an operating expense. This is in accordance with the Medicare regulation at 42 C.F.R. § 413.130(I)(3):

Cost 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:

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

Issue 4 - Organization Costs:

The Board finds that the acquisition costs claimed by the Provider are not an allowable cost to the Medicare program. The Board cites § 4508.2A of HCFA Pub. 13-4 which states in part:

Acquisition costs may be incurred by both buyer and seller during negotiations for, and consummation of, a potential CHOW transaction. Acquisition costs

commonly include:

- Appraisal costs,
- Time and expense of buyer and seller staff,
- Legal, accounting, tax, and other consulting fees,
- Other costs related to the negotiations and consummation of the transaction.

In support of its decision the Board cites the Medicare regulation at 42 C.F.R. § 413.134(b)(G) which states:

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 intermediary under paragraph (f)(2)(iv) of this section), legal fees, accounting and administrative costs, travel costs, and the costs of feasibility studies.

Id.

DECISION AND ORDER:

Issue 1 - Jurisdiction:

The Intermediary's contention that the Board does not have jurisdiction in this case is unfounded. The Board does have jurisdiction.

Issue 2 - Basis of Assets:

The Intermediary's adjustment of the basis of the Provider's assets was proper. The Intermediary's adjustment is affirmed.

Issue 3 - Interest:

The Intermediary's adjustment of the Provider's interest cost was proper. The Intermediary's adjustment is affirmed.

Issue 4 - Organization Cost:

The Intermediary's adjustment of the Provider's organization cost was proper. The Intermediary's adjustment is affirmed.

Board Members Participating:

Irvin W. Kues
James G. Sleep
Henry C. Wessman, Esquire

Date of Decision: June 02, 1998

FOR THE BOARD:

Irvin W. Kues
Chairman