ACCOUNTING UPDATE: WHAT DO HEALTHCARE COMPANIES NEED TO KNOW ABOUT TAX REFORM AND NEW ACCOUNTING STANDARDS

HFMA Lone Start Spring Institute 2018
AGENDA

- Tax Reform Impact to Healthcare Companies
- ASC 606 Revenue Recognition Standard
- ASC 842 Identifying A Lease
With You Today

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IMPACTS OF TAX REFORM ON THE HEALTHCARE INDUSTRY

HFMA Lone Start Spring Institute 2018
Tax Reform - Agenda/Topics

▶ Federal Tax
  • Tax Rate, AMT Repeal, NOL Limits
  • Limitation on Interest Expense
  • Immediate Expensing of Capital Expenditures
  • Amortization of Research and Experimental Expenditures
  • IRC 199A/20% deduction for certain pass-throughs

▶ Non-Pro fit Considerations
  • Impact of Standard Deduction, Pease Limitation, and Charitable Contribution Changes
  • Modifications to UBIT and Executive Compensation

▶ Repeal of the ACA Individual Mandate
Tax Rate Change & AMT Repeal

- Corporate Tax Rate Reduced from 35% to 21%
  - Effective January 1, 2018
  - Fiscal years use a blended rate for tax years that include the effective date of the rate change
  - For financial statement purposes recognize at the date of enactment and adjust deferred taxes accordingly

- Repeal of AMT for Corporate Taxpayers
  - Effective for tax years beginning after December 31, 2017
  - For 2018, 2019 and 2020 tax years to the extent AMT credit carryovers exceed regular tax liability, 50% of the excess AMT credit is refundable then any remaining AMT credits are fully refundable

- Net Operating Loss Carryovers
  - Effective for tax years beginning after December 31, 2017 utilization is limited to 80% of taxable income and losses have an indefinite carryover period
  - Carryback provisions repealed for tax years ending after December 31, 2017
Limitation on Deduction for Interest Expense

- Amends IRC Section 163(j) to disallow deductions for net business interest expense exceeding 30% of adjusted taxable income
- Effective for tax years beginning after December 31, 2017
- Adjusted taxable income is computed without regard to deductions for any items not properly allocable to the trade or business, business interest expense or interest income, net operating losses, 20% pass through deduction
- Before January 1, 2022 adjusted taxable income is also computed without regard to depreciation, amortization, and depletion
- Exception for taxpayers with less than $25M gross receipts for the three prior years
- Disallowed amounts are carried forward and subject to limitation under Section 382
Expensing of Capital Expenditures and Amortization of R&E Expenditures

- 100% expensing of qualified assets placed in service after September 27, 2017 and before January 1, 2023

- Phased amounts between 2023 and 2026

- For most types of property excluding real estate, definition expanded to include used property provided the taxpayer and any related party had not used the property

- In addition, Section 179 expensing is available up to $1 million per year subject to phase out for companies with qualifying property of $2.5 million or more

- Expenditures paid or incurred for R&E must be capitalized and amortized over 5 years (15 years if research is conducted abroad)

- Effective for taxable years after December 31, 2021
Pass Through Income Deduction

- Effective for taxable years after December 31, 2017
- 20% deduction on domestic qualified business income from a partnership, S corporation, or sole proprietorship
- Limited to the greater of:
  - 50% of W-2 wages with respect to the qualified business, or
  - 25% of W-2 wages with respect to the qualified business plus 2.5% of the unadjusted basis of qualified property
  - Qualified property is tangible personal property subject to depreciation and used in the qualified trade or business at the end of the taxable year
  - Certain exceptions to the limitations for smaller taxpayers
- Specified services business are not eligible. Defined as any trade or business involving the performance of services in the fields of health, law, consulting, athletics, financial services, brokerage services, or any trade where the principal asset is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management trading or dealing in securities, partnership interests or commodities.
Non-Profit Considerations

- Impact of Changes in Standard Deduction
  - Standard deduction is nearly doubled for individuals which is expected to result in fewer individuals itemizing. Many non-profits fear this will lead to a decrease in charitable giving since they will no longer have a tax benefit. Tax Policy Center estimates that charitable giving will decline by $12.3 to $19.7 billion.

- Pease Limitation Repeal & Increase in AGI Limit on Charitable Contribution Deductions
  - Pease Limitation limited benefit of itemized deductions for higher income individuals, suspension of this limitation sunsets in 2025. Charitable contribution deduction limit raised from 50% of AGI to 60% of AGI. Relief from deduction limits may encourage high income donor to give more to charity.

- Modifications to UBIT
  - Organizations can no longer use losses from one economic activity to offset gains from another economic activity resulting in increased tax due from UBIT.

- Excise Tax on Executive Compensation
  - 21% excise tax on compensation of any covered employee in excess of $1 million. Includes the 5 highest paid for the tax year or those who were covered employees in a previous year. Certain medical professionals are exempt.
Repeal of ACA Individual Mandate

- Ends the requirement for individuals to have health insurance or face a monetary penalty
- Expected to increase the number of uninsured individuals by 13 million in 2027 according to the Congressional Budget Office
- Other portions of the ACA are still in effect
- Effective for years after December 31, 2018
WHAT TAX REFORM MEANS FOR HEALTHCARE ENTITIES: FOR-PROFIT & NON-PROFIT

On Dec. 22, 2017, President Trump signed sweeping tax reform, formerly known as the Tax Cuts and Jobs Act, into law, marking the largest change to U.S. tax policy in decades.

WHAT CHANGES ARE COMING FOR HEALTHCARE COMPANIES?

To help organizations navigate the issues most impactful and urgent to the healthcare industry, we’ve prepared a summary of the major implications based on the signed legislation.

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| Repeal of the ACA Individual Mandate | The final legislation ends the requirement for individuals to possess health insurance or face a monetary penalty. This will increase the number of uninsured individuals by about 13 million in 2017, according to the Congressional Budget Office. However, large portions of the ACA are still in effect. Effective date: Effective for years after Dec. 31, 2018 | Industry view: Negative  
Comments: A sharp increase in the number of people without insurance could hurt hospitals’ finances as they treat more uninsured patients. |

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| Reduce the Corporate Tax Rate | The final legislation reduces the corporate tax from 35 to 21 percent.  
Effective date: Effective for taxable years after Dec. 31, 2017 | Industry view: Positive  
Comments: The cut in the corporate tax rate may alleviate some of the added expense from the limitation of interest rate deductibility. It could also free up funds that can be used for capital expenditures. |
| Limitation of Interest Rate Deductibility | The final legislation caps interest deduction to the sum of business interest income plus 30 percent of the adjusted taxable income of the taxpayer for the taxable year.  
Adjusted taxable income is defined similar to EBITDA for taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2022, and is defined similar to EBIT for taxable years beginning after Dec. 31, 2022. Limitation applies to both related party and unrelated party debt. Disallowed interest is carried forward indefinitely.  
Effective date: Taxable years after Dec. 31, 2017 | Industry view: Negative Inadvertent  
Comments: Earnings per share for publicly traded companies will be lower due to the limitation on interest expense deductibility, but said limitation is not expected to impact free cash flow, which will be helped by the cut in corporate tax. |
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| Immediate Expensing of Certain Capital         | The final legislation enables companies to fully expense capital expenditures for most   | Industry view: Positive
| Expenditures                                   | types of property other than real estate in 2018.                                         | Comments: This could encourage more capital spending.                             |
|                                                | Effective date: Applies until 2022 for purchases made after Sept. 27, 2017. The          |                                                                                     |
|                                                | percentage of allowable expensing will be phased out at a rate of 20 percent per year    |                                                                                     |
|                                                | from 2023 (80 percent) to 2026 (20 percent).                                              |                                                                                     |
| Amortization of Research and Experimental      | The final legislation requires that expenditures paid or incurred be capitalized and      | Industry view: Negative
| (R&E) Expenditures                             | amortized over five years (15 years for expenditures for research conducted abroad).     | Comments: Companies will no longer be able to deduct costs when they are incurred. |
|                                                | Effective date: Taxable years after Dec. 31, 2021                                        |                                                                                     |
| Pass-through Deduction of 20 Percent for       | Owners of most pass-through entities such as sole proprietorships, partnerships and      | Industry view: Neutral
| Business Owners                                 | S corporations may be entitled to claim a deduction equal to 20 percent of qualified     | Comments: The deduction will benefit service professionals who earn less than $207,500
|                                                | business income if they are not considered a prohibited specified service trade or      | if single, or $415,000 if filing jointly. On the other hand, it will not be         |
|                                                | business. While not all healthcare trades or businesses fall into this definition,      | be attractive to highly compensated business owners and could encourage them to     |
|                                                | most owner-operated clinical entities are generally considered a specified service      | consider changing their choice of entity.                                          |
|                                                | trade or business, which disallows the deduction unless the owners meet certain taxable |                                                                                     |
|                                                | income thresholds.                                                                       |                                                                                     |
|                                                | Effective date: Taxable years after Dec. 31, 2017                                        |                                                                                     |

**NON-PROFIT CONSIDERATIONS**

| Increase the Standard Deduction; Limit the    | The final legislation nearly doubles the standard deduction for individuals and married  | Industry view: Negative
| State and Local Tax Deduction                 | couples filing jointly and limits the deduction for state and local taxes to $10,000.  | Comments: The increase in the standard deduction, combined with the limitation on   |
|                                                | Effective date: Taxable years after Dec. 31, 2017                                        | the deduction for state and local taxes, will cause fewer individuals to itemize,   |
|                                                |                                                                                           | which many nonprofits fear may lead to a reduction in overall giving. It has been   |
|                                                |                                                                                           | estimated by the Tax Policy Center that charitable giving will decline between $12.3|
|                                                |                                                                                           | and $19.7 billion.                                                                  |

| Increase the Charitable Contribution Deduction Limit and Repeal the “Pease” Limitation | The Act increases the charitable contribution deduction limit for an individual to 60 percent of his or her adjusted gross income (ACI), up from the current limit of 50 percent. The Act repeals the “Pease” limitation, whose original intent was to raise tax revenue by increasing the taxable income for high-income earners. It does this by reducing the value of benefits of several itemized deductions (including charitable contributions) once a taxpayer’s ACI reaches a certain amount ($269,500 for single filers and $313,800 for married couples filing jointly). The suspension of this limitation sunsets in 2025. |
|                                                                                       |                                                                                           | Industry view: Positive
<p>|                                                                                       |                                                                                           | Comments: The increase in deduction limits may be an incentive for high-income donors to give more to charity, as they can claim more of their donations as a charitable deduction. Since the “Pease” limitation reduced the benefits of itemized deductions (including charitable contributions), repealing it allows high earning taxpayers to go back to enjoying the full benefits of these deductions. It is anticipated that this measure could help prompt high earners to donate more to charity. |</p>
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| **Impose an Excise Tax on Endowments of “Applicable Educational Institutions”** | The law includes a new excise tax of 1.4 percent on the net investment incomes of applicable educational institutions. The term “applicable educational institution” refers to an educational institution which a) had at least 500 students during the preceding taxable year; b) the aggregate fair market value of the assets of which at the end of the preceding taxable year (other than those assets which are used directly in carrying out the institution’s exempt purpose) is at least $500,000 per student of the institution; and c) more than 50 percent of the students are located in the United States. **Effective date:** Taxable years after Dec. 31, 2017 | **Industry view:** Negative  
**Comments:** Healthcare systems that have post-secondary schools could be caught by this provision. Under the new law, when making the determination of whether the asset threshold is met, an institution will have to include the income and assets of certain related organizations. |
| **Repeal of Advance Refunding Bonds**                                       | **Effective date:** Applies to advance refunding bonds issued after Dec. 31, 2017                                                                                                                                              | **Industry view:** Negative  
**Comments:** Eliminates advance refunding for municipal bonds by making interest on advance refunding bonds taxable. |
| **Imposes Excise Tax on Executive Compensation**                           | The Act imposes a 21 percent excise tax on the compensation of any covered employee in excess of $1 million. The term “covered employee” means any employee (including any former employee) of an applicable tax-exempt organization if the employee a) is one of the five highest compensated employees of the organization for the taxable year, or b) was a covered employee of the organization (or any predecessor) for any preceding taxable year beginning after Dec. 31, 2017. Certain medical professionals are excluded from the definition of a covered employee. **Effective date:** Effective for taxable years beginning after Dec. 31, 2017 | **Industry view:** Negative  
**Comments:** Tax-exempt organizations will need to factor this new excise tax into their overall tax planning and be aware that this extra payment may require budget cuts elsewhere. Remuneration of a covered employee paid by an applicable tax-exempt organization includes amounts paid by a related person or government entity if the person or entity controls, or is controlled by, the applicable tax-exempt organization, is controlled by a person, or persons, that control the organization; or is a supported or supporting organization. A related organization can be taxable or tax exempt. |
| **Modifications to the Unrelated Business Income Tax (UBIT)**              | The Act disallows tax-exempt organizations to take the business losses from one economic activity and deduct them from the gains of another economic activity. Organizations could, however, use one year’s losses on the same unrelated business to reduce taxes on another year’s operation of the same unrelated business. The provision is effective for taxable years beginning after Dec. 31, 2017. NOLs arising before Jan. 1, 2018, are not subject to the rule. | **Industry view:** Negative  
**Comments:** There are many unanswered questions about this UBIT provision and there may be opportunities for additional tax planning. On the other hand, the corporate income tax rate is decreased from 25 to 21 percent, which means nonprofits will pay a lower tax rate on the UBIT than they are currently. |
| **Certain Fringe Benefits Taxed as UBI**                                   | A tax-exempt organization includes as UBI any amounts paid or incurred by the organization for any qualified transportation fringe or any parking facility used in connection with qualified parking.  
UBI does not include the amounts described above to the extent connected with an unrelated trade or business. **Effective date:** Tax years beginning after Dec. 31, 2017 | **Industry view:** Negative  
**Comments:** Those provisions were enacted to equalize the treatment between taxable corporations that can no longer deduct these amounts and nonprofits. Guidance will be needed for the allocation of depreciation and other costs with respect to facilities used for parking. |
IMPACTS OF ASC 606 ON THE HEALTHCARE INDUSTRY

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OVERVIEW OF THE 5 STEP MODEL

Core principle:

Recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.
STEP 1- Identify the Contract

**Determination if a Contract Exists**

- Legally enforceable contract in place
- Contract approval may be in writing, orally, or through customary business practices
  - Has the patient signed any forms (admitting, patient responsibility)?
  - If patient refuses or is unable to sign any forms has an oral or implied contract been established through customary business practices?
  - Advanced scheduled healthcare services (e.g. elective surgeries) can be considered implied or oral contracts
  - Payment terms can be identified
  - Contract has commercial substance

- **Determination of ability to pay**
  - Past history with patient
  - Qualification under charity care policy
  - Medicaid pending status
  - Historical experience
STEP 1 - Identify the Contract

Application of the Portfolio Approach

• ASC 606 allows for a portfolio approach as a practical expedient to account for patient contracts as a collective group rather than individually
  – Similar characteristics among contracts (or performance obligations)
  – Expectation should be that the effect would not be materially different than an individual contract approach

• Considerations for portfolios
  – Type of service: inpatient, outpatient, ER, elective, non-elective, etc.
  – Type of payor: insurance contract, co-pay, deductible, governmental, uninsured, charity, etc.
    – May be multiple payors (insurance and co-payment)
    – May also consider size of co-pay or deductible (high deductible vs low deductible plans)
  – Timing of contracts
  – A combination of the above may be considered
STEP 2 - Identify Separate Performance Obligations

There are some healthcare providers where the performance obligation may be unclear. Some examples may include:

- Continuing Retirement Care Communities - Advanced Fees (determine the future obligation of the CCRC)
- Outcome based reimbursement models (performance obligation may not yet be complete at the time services are performed)
- Some providers may perform additional procedures (additional care coordination or case management services) that may or may not be promised
- Providers selling medical devices and services (may need to evaluate the extent of future services)
- Providers allowing follow up services (performance obligation may extend beyond initial services)
- Pathology or other lab work (usually based on deliver of the results)
- Shared Risk Arrangements
- Accountable Care Organizations
- Patient Centered Medical Homes
- Quality Incentive Programs
STEP 3 - Determine Transaction Price

• Price concessions versus impairment losses (i.e. contractual allowance versus bad debt)
  – Implicit price concession versus acceptance of credit risk
  – Factors to consider (if either one is met an implicit concession exists):
    – Customary business practice of not performing a credit assessment prior to providing services
    – Continuing to provide services to a patient (or patient class) even when historical experience indicates that it is not probable full payment will be received
• When the expectation is to accept a lower amount of consideration, the promised consideration is variable and therefore a price concession exists
• Most-likely versus Expected Value
• BAD DEBT EXPENSE.......BELOW THE LINE
  • Recent Press Releases and Guidance
Step 3 - Determine the Transaction Price

Genesis

On January 1, 2018, Genesis adopted Accounting Standards Codification Topic 606, Revenue from Contracts with Customers (ASC 606). Results for reporting periods beginning after January 1, 2018 are presented under ASC 606, while comparative information has not been restated and continues to be reported under the accounting standards in effect for those periods. The impact of applying ASC 606 to the quarter ended March 31, 2018 was a $24.8 million implicit price concession, directly reducing net revenues, which previously would have been recorded as a provision for losses on accounts receivable.

LabCorp

In LabCorp Diagnostics, the impact of the accounting change reduced revenue and increased margins, as bad debt is treated as a reduction in revenue rather than selling, general and administrative expense. The accounting change had no impact on adjusted operating income or cash flow. 4.4% reduction in revenue
STEP 4 - Allocate the Transaction Price

• Healthcare Providers
  – For most services provided by healthcare providers this is not an issue since services are performed and delivered prior to invoicing the third-party payors and patients.
  – For some healthcare services, there may be separate and distinct performance obligation. As a result, the revenues received for those services may need to be recognized over a period of time. Examples of separate and distinct performance obligations could be:
    – Continuing Care Retirement Community (CCRC) - Contracts with patients can last several years
    – Ancillary Services or Rehab - Some providers offer follow up visits that can last months or years
    – Episodic Care (Skilled Nursing / Home Health) - Some payors will provide a portion of the costs up front which should be matched with the related services provided
STEP 5 - Recognize Revenue

• Healthcare Providers - if elements of contract are met, recognize revenue when the services are performed

• Ensure all conditions are met and no future performance obligations exist
RESOURCES

• **Updated!** *BDO Knows: Revenue from Contracts with Customers (newsletter)*

• **Updated!** *BDO Knows: Revenue from Contracts with Customers (practice aid)*

• **NEW!** *BDO Knows: Presentation and Disclosure*

• **NEW!** *BDO Knows: Exploring Transition Method*

• BDO Resource Webpage - additional publications and contact information
  – [https://www.bdo.com/services/assurance/revenue-recognition/overview](https://www.bdo.com/services/assurance/revenue-recognition/overview)
IMPACTS OF ASC 842 ON THE HEALTHCARE INDUSTRY - LEASE IDENTIFICATION

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IDENTIFYING A LEASE

Right to control use of the identified asset depends upon:

- Right to obtain economic benefits from the use of the identified asset (e.g., through using, holding, or subleasing the asset).

- “Economic benefits” is fairly broad

- Consider within defined scope of customer’s contractual right to use the asset

- Right to direct the use of an identified asset. This exists when customer has the right to direct how and for what purpose the asset is used, including the right to change how and for what purpose the asset is used, throughout the period of use.
IDENTIFYING A LEASE: THERAPEUTIC ULTRASONIC MACHINE

Provider enters into a 5-year contract with a medical device company (Supplier) for the right to use a therapeutic ultrasonic device to treat patients musculoskeletal problems. The machine are configured to each individual patient’s needs and are swapped out after each series of treatment for a new machine for every patient.

Provider makes all of the decisions about the use of the machines and does all of the configuration to each machine when received. The arrangement does NOT contain a lease.
IDENTIFYING A LEASE

Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use.

- A supplier’s right to substitute an asset is substantive only if both of the following conditions exist:
  - The supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting an asset, and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time).
  - The supplier would benefit economically from the exercise of its right to substitute the asset (that is, the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).
Provider enters into a 5-year contract with a medical device company for the right to use a bone sculpting device to use in its OR and used by the surgeons.

The provider has the right to trade out the machines.

No economic benefit to the medical device company (and the machine is physically located at the provider’s location), as a result substitution right is not deemed substantive.

Under 840 - The arrangement does not contain a lease.
Under 842 - The arrangement DOES contain a lease.
IDENTIFYING A LEASE: RADIATION ONCOLOGY MACHINE

- Provider enters into a 5-year contract with the Supplier for the right to use an oncology machine to treat its patients.
- Each machine requires a large set up process to install each machine, special radiation proof walls and other specific modifications to the building. The machine is not easily substituted and is costly.
- The Provider has the ability to direct the use of the machine.

The arrangement does contain a lease.
IDENTIFYING A LEASE: JOINT VENTURE

• Contract combinations: multiple contracts should be combined when entered into with the same counterparty if:
  - The contracts are negotiated as a package
  - The price in one depends on the other
  - Underlying assets conveyed by the contracts are a single lease component

• Non-lease components: if an arrangement contains both lease and non-lease components, they must be accounted for separately
  - Lessees can elect a practical expedient to combine and account for as one lease
✓ **BDO Knows: Topic 842, Leases**

✓ **BDO Knowledge Webinar (Self study):**

✓ **BDO Alert:**
THANK YOU