

For-Profit Healthcare Organizations and the Changing Tax Landscape

May 17, 2017

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Healthcare Tax Planning In A Falling Rate Environment

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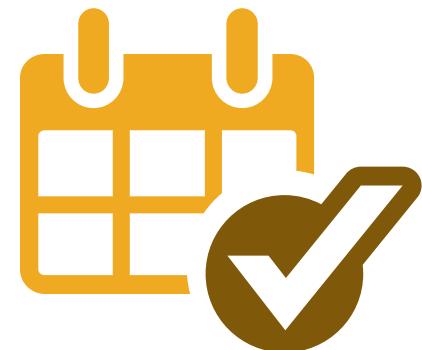
Presented by:

Scott Ford

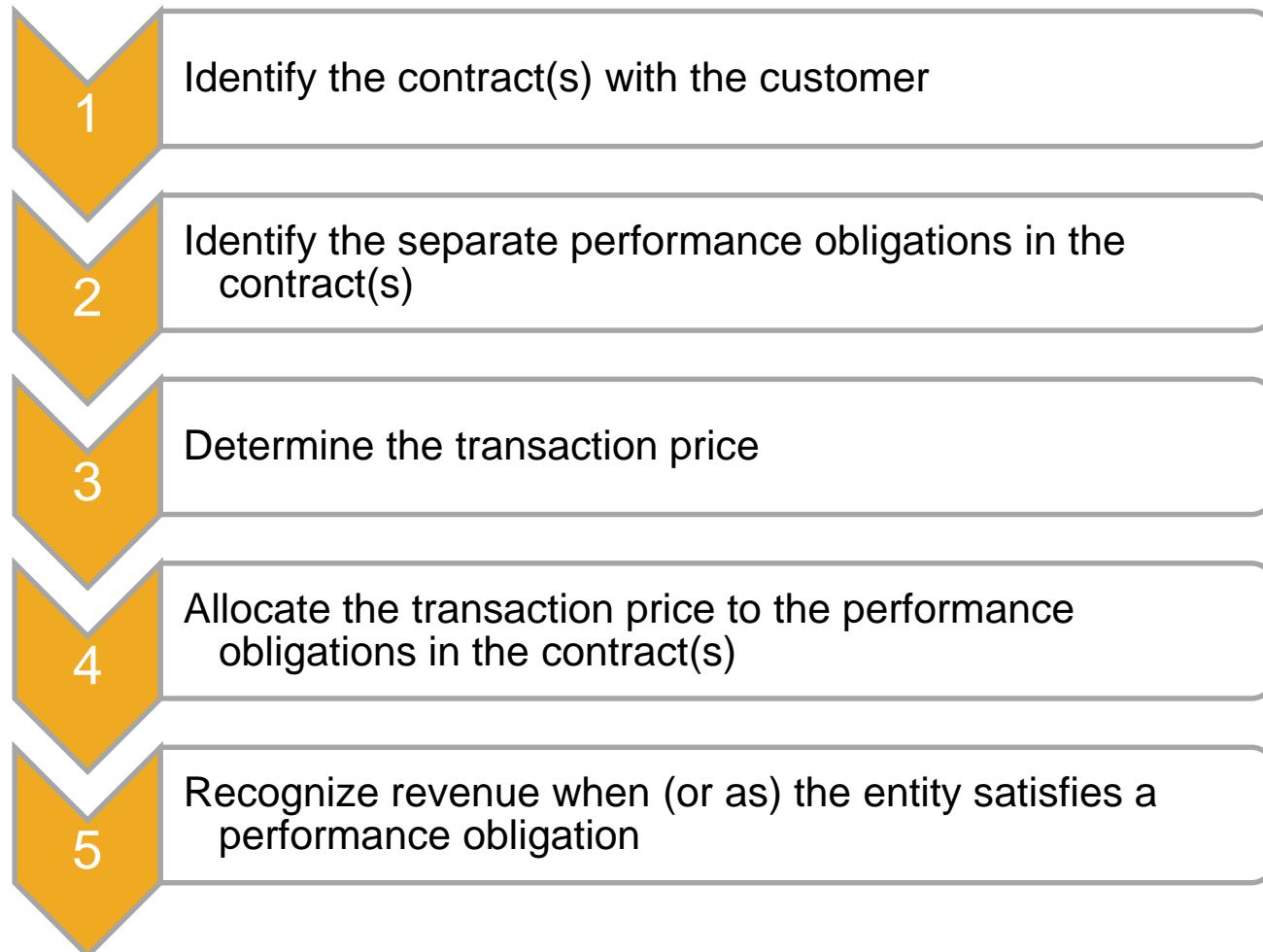
Tax Partner - Healthcare

Agenda and Objectives

- Tax impact of new GAAP revenue recognition requirements
- Discuss the current uncommon accounting method planning environment
- Provide update on tangible asset related accounting methods
- Provide update on other accounting methods
- Questions



Five-Step Model to Recognize Revenue



Tax Considerations

Effective date of new standard:

- Public entities, certain not-for-profit organizations, and certain employee benefit plans: annual or interim reporting periods beginning after Dec. 15, 2017. (Early adoption as of the original effective date of Dec. 15, 2016, is permitted.)
- All other entities: annual reporting periods beginning after Dec. 15, 2018, and interim reporting periods beginning after Dec. 15, 2019. (Early adoption is permitted, but it can be no earlier than the effective date permitted for public entities.)
- A change in GAAP revenue recognition does not automatically change TAX revenue recognition methodology
- Recommended Next Steps:
 - Companies need to evaluate if the new GAAP method results in a method change for tax purposes
 - What record keeping requirements will the company need if GAAP and TAX revenue recognition procedures are not aligned
 - The IRS issued Notice 2017-15 requesting comments on the possible effects of the new revenue recognition standard to taxpayers
- **Important to make sure that tax considerations are part of the upfront discussion and not an after thought**

Unique Accounting Methods Planning Environment

Trump Administration Tax Proposal

- Corporate Taxation
- Reducing the top corporate rate from 35 percent to 15 percent
- Eliminating the corporate alternative minimum tax
- Individual Taxation
- Reducing the top individual rate from 39.6 percent to 35 percent
- Taxing income from pass-through entities at 15 percent
- Eliminating the 3.8 percent tax on net investment income
- Eliminating the individual alternative minimum tax
- Eliminating all itemized deductions with the exception of mortgage interest and the charitable contribution deduction
- Doubling the standard deduction
- Repealing the estate tax

Unique accounting method planning environment

Several highly effective tax planning strategies are based on tax return elections or automatic accounting method changes that can be made until the timely filing date for the tax return, as late as the 15th day of the ninth month after the close of the year if properly extended. Offering more time to consider tax reform legislation.

Tax planning that can be implemented after year end but before timely tax return filing

Accelerating deductions related to software development costs

Performing a cost segregation analysis of current-year construction projects or those completed in recent years to currently or retroactively accelerate tax depreciation on those assets

Making a partial disposition election and deducting the related removal costs

Scrutinizing capitalized improvements for deductibility

Adopting a favorable tax accounting method to currently deduct qualified short-term prepaid expenses if one is not already in place

Adopting a method of accounting to defer qualifying advance payments for services

Polling Question # 1

Within your Organization how involved are you the income tax process?

- a. Active
- b. Somewhat
- c. As needed – typically to prepare supporting schedules
- d. Not at all



How you can take advantage of the new rates?

Timing differences now create permanent cash

- Typically timing difference are NPV opportunity
- Lower rates mean accelerating deductions permanently reduce tax liabilities
- Example A: Assume a 40% tax rate in years 1 and 2. Taxpayer can either deduct \$100 in year 1 or year 2. Taking the deduction in either year 1 or year 2 reduces the tax liability by \$40 ($\$100 \times 40\%$). However, taking the benefit in year allows you to invest/earn the \$40 for one year. Often times tax fees associated with documentation/method change equal the NPV of the accelerated deductions.
- Example B: Assume same facts except that in year 1 the tax rate is 40% and in year 2 the tax rate is 15%. Taking the deduction in year 1 rather than year 2 permanently saves the taxpayer \$25: Difference in tax rates (25%) X the \$100 deduction.

Common Method Changes – Timing differences

- Depreciation/Amortization
 - Cost Segregation Study
 - Review of fixed asset schedules to identify assets with improper methods of depreciation/amortization
- Identify costs eligible for immediate expenses (GAAP may have capitalized)
- Partial dispositions
 - Notice 2017-6
 - Taxpayers who adopted TPR for 2014 tax year but may not have thoroughly analyzed expenditures in 2014 and 2015
 - Taxpayers who have not made book/tax conformity election in 2014 and 2015
- Intangible Asset Regulations
 - Change to adopt final Treas. Reg. Sec. 1.263(a)-4 and -5 regulations for:
 - Costs incurred to acquire and/or create intangible assets
 - Amounts paid in the process of investigating or otherwise pursuing a transaction are subject to capitalization
 - Transaction costs
 - Prepaid expenses
 - 12 months after the first date on which the taxpayer realizes the right or benefit; or
 - The end of the taxable year following the taxable year in which the payment is made.
 - Annual election not to apply the 12-month rule to similar transactions.

Common Method Changes - continued

- Advance Payments
 - General rule is to recognize income upon receipt
 - Revenue Procedure 2004-34 one-year deferral for advance payments related to goods or services
- Internally Developed Software Costs
 - General rule is to expense the costs as incurred for tax but costs might be capitalized for financial reporting purposes
 - Taxpayer may have treated costs similar to other software costs and capitalized the development costs and are amortizing over 3 years.
 - Taxpayers need to evaluate the types of costs incurred for the software projects to identify those costs that can be currently deductible
- IBNR
 - General rule is to deduct the costs associated with a self insured benefit in the year the liability becomes fixed and determinable
 - In some cases the accrual for financial reporting might be viewed as a reserve and none of the accrued liability was deducted
 - Automatic change to deduct incurred but not yet reported self insured benefit plan liabilities in year the all events test is met

Common Method Changes - continued

Nonaccrual Experience Method (NAEM)

- Allows healthcare service providers to except from accrual income the portion of revenue they have determined will not be collected based on their historical collection rates.
- Rev Proc 2011-46 Safe Harbor
 - Allows taxpayers to recognize 95% of current eligible accounts receivable

5 ways to identify 'hidden' tax deductions

1. Review your Company's Deferred Tax Assets
2. Does your Company's DTA related to Allowance for Bad Debt equal the ending Allowance amount per the Financial Statement?
3. Have you recently moved into, opened or renovated office space?
4. Do you have Deferred Revenue on your Financial Statements?
5. Does your company develop any software internally?

Polling Question #2

Accelerating deductions in a falling rate environment could create permanent savings for my organization?

- a. True
- b. False



Questions???

Thank you

Scott Ford
Direct 615.360.5536
Scott.Ford@crowehorwath.com

Identifying Property Tax Solutions The Healthcare Industry

For-Profit Healthcare Organizations and the Changing Tax Landscape

May 17, 2017

Agenda

- Introduction to Property Tax
 - What is property tax, property, and taxable?
 - Terminology
 - Ad Valorem Cycle
- Healthcare Industry
 - Complex Property Tax Exemption Rules
 - The Changing Interpretation of Non-Profit Exemptions
- Solutions
 - How Best to Manage the Process and Potential Liabilities
 - Taxability and Assessment
 - Identification of High Value Healthcare Personal Property
 - Derivation of Fair Market Value/Taxable Base
 - Functional and Economic Obsolescence
 - Obsolescence Example



Introduction to Property Tax

What is property tax?

- Ad Valorem taxation, meaning that property is taxed according to the value of the property.
- Primary source of income for local government such as cities, counties, school districts, and special districts.
- The one tax that is based on an opinion, of value, and therefore negotiable.
- The laws vary by state and the administrative process can be governed on either a local or state level depending on the state and type property.
- No two states have identical property tax rules, although commonalities exist.

What is property?

- Property is anything capable of private ownership
- Typically classified as real estate/real property or as personal property either tangible or intangible property

What is taxable?

- Taxability basic concept is that all property is taxable unless exempt.
- There are both full and partial exemptions.
- Every state has numerous exemptions whether general or specific to type property or industry.
- Most states have exemptions specific to healthcare and every state has exemptions allowable to healthcare industry property.

Introduction to Property Tax - Terminology

- Ad Valorem - Latin for “According to Value”
- Lien Date - The legal date that a tax lien will attach to the property
- Assessment Date - The date an assessing jurisdiction must value the property for taxation
- Assessment Ratio - The ratio of assessed value to the market value of property
- Assessed Value - $(\text{Fair Market Value}) \times (\text{Assessment Ratio}) = (\text{Assessed Value})$
- Market Value - The most probable price for which property will sell on the open market
- Real Estate - Land and appurtenances affixed to the land
- Business Personal Property (BPP) – Business owned property that is not real property
- Functional Obsolescence - The loss in value caused by inefficiencies or inadequacies of the property itself when compared to a more efficient or less costly replacement property
- External (Economic) Obsolescence - The loss in value of a property caused by factors external to the property, such as increased cost of compliance with government regulation, increased competition, economic changes, regulatory changes, and industry changes
- Situs – Taxable location of a property
- Exemption – excludes all or part of a property’s value from taxation
- PILOT – Payment in lieu of tax
- Rendition/Return – A statement listing the taxable status of property

Introduction to Property Tax – Ad Valorem Cycle

Compliance – Typically Spring but varies by State

- Identification and Filing of Potential Exemptions
- Preparation & Submission of Business Personal Property Returns/Renditions
- 20+ Filing Deadlines (typically the 1st & 15th of each month)
- 17,000+ Property Tax Jurisdictions
- Local & State Assessed Property Filings

Advisory – Typically Summer but varies by State

- Evaluation & Appeals
 - Informal Negotiations with Assessors
 - Formal Review Boards
 - Formal Litigation – If Necessary

Administrative – Typically Fall and Winter but varies by State

- Tax Bills & Accruals
 - Jurisdictions Begin Collection
 - Value Verification
 - Payment Processing

Healthcare Industry

Complex Property Tax Exemption Rules

Healthcare industry has complex entities with both non-profit and for-profit entities.

- Hospitals are eligible for exemptions from property taxes in all fifty states.
- No state allows full property tax exemptions to for-profit hospitals; each one contains a limitation from generating revenue for private interests.
- States also may impose other limitations to gain tax-exempt status.

Thirty-two different states have exemptions that apply only to hospitals or health care centers, but even within this group, significant variations exist.

- Washington, Kansas, and New York, require that for property to be exempt it must be used primarily or exclusively for hospital purposes.
- Indiana and Colorado require that the property be owned by a hospital and used for charitable purposes.
- Nevada specifically exempts the land and buildings owned by hospitals, but not personal property. This property can only be granted exemption under a statute that applies to charitable organizations generally.
- Alabama exempts all property used for hospital purposes up to \$75,000.

Healthcare Industry

Complex Property Tax Exemption Rules

Eighteen states do not have a property tax exemption that applies specifically to hospitals. In each of these states, hospitals must rely on a statute that exempts charitable institutions or personal property in general.

- Usually, these provisions require the property be used and the organization owning it be exclusively or primarily for charitable purposes. Most of these apply a test similar to the federal charity-care standard.
- Also some states impose additional restrictions. Iowa only allows an exemption for a maximum of 320 acres of real property held by charitable institutions and used for tax-exempt purposes.

A majority of states have adopted some measure of community benefit as a requirement for property tax exemption.

- Twenty-nine states require hospitals to qualify as tax-exempt organizations under I.R.C. § 501(c)(3) to be eligible for exemption from property taxes.
- Eighteen states impose an independent community benefit requirement. That often deviate significantly from the federal standard.
- California accepts a wide variety of activities as evidence of community benefit
- Florida, by contrast, conditions property tax exemption on qualification under I.R.C. § 501(c)(3), but also requires all nonprofit hospitals to provide a separate, state-level community benefit, which is defined solely as the provision of charity care and participation in the Medicaid program.

Healthcare Industry

The Changing Interpretation of Non-Profit Exemptions

Hospitals throughout the country are a target for additional taxes as they currently benefit from billions of dollars of tax exemptions each year as demonstrated by a New Jersey Tax Court case from 2015, *AHS Hospital Corporation, d/b/a Morristown Memorial Hospital v. Town of Morristown*

- Issued by Judge Vito Bianco, the ruling essentially held that Morristown Medical Center, a New Jersey not-for-profit hospital organization, was functioning as a for-profit entity, and therefore was not exempt from New Jersey property tax. The judge stated: "If it is true that all non-profit hospitals operate like the hospital in this case . . . then for purposes of the property tax exemption, modern non-profit hospitals are essentially legal fictions." Judge Bianco found that the hospital "operated and used the property for a profit-making purpose" by, in part, providing substantial loans, capital, and subsidies to for-profit entities, including physician groups.
- These practices are not uncommon for tax-exempt hospitals.
- The judge focused more on the hospital's operations than its benefit to the community. This analysis is different from the approach taken in other cases, which typically focuses more on community benefit
- In 2015, the New Jersey Tax Court upheld the denial of a medical center's property tax exemption, with limited exceptions, finding that the hospital properties were substantially used for profit.
- New Jersey Senate and Assembly committees on January 7, 2016, approved proposed legislation that would require nonprofit hospitals to make "community service contributions" to maintain their property tax exemption. However, Governor Christie "pocket vetoed" the measure by taking no action within the requisite timeframe after the end of the legislative session.

Healthcare Industry

The Changing Interpretation of Non-Profit Exemptions

In contrast to Morristown, *Provena Covenant Med. Ctr. v. Dep't of Revenue*, 925 N.E.2d 1131 (Ill. 2010), Provena, focused on the amount of charity care that was provided.

- The IL DOR argued that they were not operating in a charitable manner, the state enacted a law in 2012 requiring tax exempt hospitals to provide a certain level of charity care and community benefits commensurate with the value of their property tax exemption.
- Illinois-based nonprofit hospitals can claim a property tax exemption only if they can prove that factors such as charity care, preventive care, medical research and professional training are equal to the value of the exemption.
- Recently, the Illinois Court of Appeals found the 2012 statute to be inherently unconstitutional because it requires a hospital to "pay for its property tax exemption with certain services of equivalent value." In contrast, the Illinois Constitution requires exempt property to be used exclusively for charitable purposes. The case is: *The Carle Foundation v. Cunningham Twp.* (Ill. Ct. App. January 5, 2016).
- According to various news reports, the Illinois Department of Revenue will temporarily halt its review of property tax exemption applications for nonprofit hospitals during the pendency of appeals

In Texas nonprofit hospitals must provide community benefits as a condition of state tax exemption.

- Texas law gives a hospital four alternatives that cover combinations of charity care and government-sponsored indigent health care in amounts equal to varying sums of net patient revenue.

For jurisdictions that do not have laws in place, critics are starting to challenge such exemptions.

Polling Question

What is the primary difference in deciding not to allow an exemption in the cases of *Morristown* and *Provena*, respectfully?

- a. For-Profit and Non-Profit State Statute Definitions
- b. Profit Element and Amount of Charitable Care
- c. I.R.C.501(c)(3) status and Affordable Care Act
- d. Real Estate and Business Personal Property



How Best to Manage the Process and Potential Liabilities

A Goal Without a Plan Is Only a Wish

- Keep a property tax calendar for returns, exemptions, value notices, appeal deadlines and tax bills.
- Potential Exemptions by state and type property should be identified prior to January 1 of each year including healthcare specific, general, and for business personal property exemptions – i.e. intangibles such as embedded warranties and embedded software.
- Identify ghost, non existing assets, that are still on the books
- Review classification of assets for appropriate depreciation schedules
- Identify property and equipment with obsolescence issues. Please note, obsolescence is a loss in value for assessment /valuation purposes. It is not defined as no longer functional for the purpose intended which is the engineering or operational definition of obsolete.
- Prepare value analysis on all significant properties. Typically 70%+ of property tax liability is in less than 30% of properties.
- Be proactive with assessors regarding exemptions, valuations, and issues. All may be presented in cover letters & reports with returns and applications then follow up discussions.
- Utilize, grow, or hire dedicated property tax professional with healthcare experience if possible as it is a complex industry for property tax responsibility.

Active Management – How Can Value Be Managed?

- Asset Utilization Analysis – Obsolescence Negotiations
- Asset Classification & Depreciation Optimization
- Capitalized Asset Cost Segregation
- Embedded Software & Intangible Segregation

Taxability & Assessment – Business Personal Property (BPP)

- Tangible Business Personal Property (BPP)
 - Furniture & Fixtures
 - Machinery & Equipment
 - Computer Equipment
- Categories
 - Inventory
 - Fixed Assets
 - Leasehold Improvements
 - Intangibles
- Any Owned Property – Moveable vs. Permanently Affixed
- Not All States Tax BPP
- Almost all States exempt intangibles
- All States have exemptions allowable for Healthcare property

Taxability & Assessment – Business Personal Property (BPP)

38 States & the District of Columbia Tax BPP

1. Alabama	11. Idaho	21. Missouri	31. Tennessee
2. Alaska	12. Indiana	22. Montana	32. Texas
3. Arizona	13. Kansas	23. Nebraska	33. Utah
4. Arkansas	14. Kentucky	24. Nevada	34. Vermont
5. California	15. Louisiana	25. New Mexico	35. Virginia
6. Colorado	16. Maine	26. North Carolina	36. Washington
7. Connecticut	17. Maryland	27. Oklahoma	37. West Virginia
8. District of Columbia	18. Massachusetts	28. Oregon	38. Wisconsin
9. Florida	19. Michigan	29. Rhode Island	39. Wyoming
10. Georgia	20. Mississippi	30. South Carolina	

11 States Tax Inventory Regularly

1. Alaska	7. Oklahoma
2. Arkansas	8. Texas
3. Kentucky	9. Vermont
4. Louisiana	10. Virginia
5. Massachusetts	11. West Virginia
6. Mississippi	

Taxability & Assessment – Business Personal Property (BPP)

Original Cost	Year's In Service	% Good Factor	Fair Market Value	Assessment Ratio	Taxable Value	Tax Rate	Tax
\$ 2,000,000	1	80%	\$ 1,600,000	40%	\$ 640,000	2.25%	\$ 14,400
\$ 500,000	2	70%	\$ 350,000	40%	\$ 140,000	2.25%	\$ 3,150
\$ 1,000,000	3	60%	\$ 600,000	40%	\$ 240,000	2.25%	\$ 5,400
\$ 250,000	4	50%	\$ 125,000	40%	\$ 50,000	2.25%	\$ 1,125
\$ 17,500,000	5	40%	\$ 7,000,000	40%	\$ 2,800,000	2.25%	\$ 63,000
\$ 750,000	6	30%	\$ 225,000	40%	\$ 90,000	2.25%	\$ 2,025
\$ 8,000,000	7	20%	\$ 1,600,000	40%	\$ 640,000	2.25%	\$ 14,400
\$ 180,000,000	8	20%	\$ 36,000,000	40%	\$ 14,400,000	2.25%	\$ 324,000
\$ 27,500,000	9 or More	20%	\$ 5,500,000	40%	\$ 2,200,000	2.25%	\$ 49,500
\$ 237,500,000			\$ 53,000,000		\$ 21,200,000		\$ 477,000

Identification of High Value Healthcare Personal Property

Tangible Business Personal Property (BPP)

- Medical devices, including devices for diagnostics and monitoring
- Surgical robots
- Medical imaging systems
- Telemedicine
- Electronic medical records processing and storage
- Medical diagnosis and expert systems
- Nuclear medicine equipment
- Radiation oncology and linear accelerator equipment
- Pharmaceutical and biotechnology research equipment
- Genetic testing equipment

Functional Obsolescence Triggers

- Functional obsolescence is the loss in value or usefulness of an asset caused by inefficiencies or inadequacies of the asset itself, when compared to a more efficient or less costly replacement asset.
- Fluctuations in the following metrics – Functional:
 - Technological Advances
 - Excess Operating Costs
 - Lack of Utility
 - Over-Capacity
 - Inadequacy in Design
 - Excess Capital Investment

Economic Obsolescence Triggers

- Economic obsolescence is the loss in value caused by adverse conditions external to the assets, such as poor market demand for the product or service, industrial reorientation, unavailability of transportation, and governmental regulation.
- Fluctuations in the following metrics – Economic:
 - + \$ of Raw Materials
 - + \$ of Labor
 - + \$ of Utilities
 - - Revenue
 - - Profitability
 - - Profit Margins
 - - Returns on Investment
 - - Product Demand
 - - Product Pricing
 - + Interest Rates
 - + Government Regulations

Polling Question



What is the best method to limit property tax liability?

- a. Identify applicable exemptions
- b. Review fixed assets for ghost assets, classification and obsolescence
- c. Perform value analysis and be proactive with assessors
- d. All of the above

Thank you



W. Ted Clark
National Property Tax Leader
Main +1 214 777 5200
Direct +1 832 661 3075
ted.clark@crowehorwath.com

Moiz Mohammed, CMI, MRICS
Senior Manager – Property Tax Services
Office +1 312.606.7163
Mobile +1 972.489.7876
moiz.mohammed@crowehorwath.com