Medicare

Provider Reimbursement Manual - Part 1

Department of Health and Human Services (DHHS)

HEALTH CARE FINANCING ADMINISTRATION (HCFA)

Transmittal 415 **Date: MAY 2000**

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NEW/REVISED MATERIAL--EFFECTIVE DATE: Cost Reporting Periods Beginning on or after July 3, 2000. The following changes are required by §4404 of the Balanced Budget Act of 1997 (BBA).

Section 104.10, Historical Costs, reflects the limit on the valuation of a depreciable asset that may be recognized in establishing an appropriate allowance for depreciation and interest on capital indebtedness after a change of ownership that occurs on or after December 1, 1997.

Section 104.14, Purchase of Facility as Ongoing Operation, conforms to the changes in §104.10 and specifies that for changes of ownership that occur on or after December 1, 1997, no gain or loss is recognized on the sale.

Section 104.17, Useful Life of Depreciable Assets, describes the useful life to be used by the purchaser of a used asset acquired on or after December 1, 1997. As described below, this section is also revised to allow the use of the 1998 Edition of the AHA Useful Lives of Depreciable Hospital Assets.

Section 104.19, Salvage Value, adds that for assets acquired on or after December 1, 1997 and subject to the historical cost limitations under the BBA, salvage value need not be taken.

Section 130, Disposal of Assets, adds additional cross references and specifies that if a sale or scrapping occurs on or after December 1, 1997, no gain or loss is recognized.

Section 132, Gains or Losses on Disposal of Depreciable Assets (Excluding Involuntary Conversions), conforms to the changes in §130 in specifying that gains or losses are recognized only on sales or scrappings that occur before December 1, 1997.

CLARIFICATION/MANUALIZATION--EFFECTIVE DATE: NOT APPLICABLE. The following changes are added to clarify existing instructions.

Section 104.24, Bona Fide Sale, is added to provide a the definition of a bona fide sale.

Section 110, Sale and Leaseback and Lease-Purchase Agreement , describes the treatment of rental charges when the provider undergoes a change of ownership during the lease period.

Section 132.2, Computation of Net Depreciation Adjustment Upon Disposal of Depreciable Assets Acquired Under the Program, adds an example to illustrate the computation of net depreciation adjustment after the provider becomes subject to the prospective payment system for hospital inpatient capital-related costs (capital PPS).

Section 132.3, Allocation of Net Depreciation Adjustments, replaces the reference to the Social Security Administration and adds an example of the allocation where the provider is subject to capital PPS.

NEW/REVISED MATERIAL--EFFECTIVE DATE: For Assets Acquired on or after March 1, 1998

Section 104.17, Useful Life of Depreciable Assets, allows use of the 1998 Edition of the AHA Estimated Useful Lives of Depreciable Hospital Assets published by the American Hospital Association for assets acquired on or after March 1, 1998. A provider who used the 1993 edition of the AHA guidelines for assets purchased on or after March 1, 1998, and before publication of this transmittal, and who now wishes to change to the 1998 guidelines may do so. However, if the provider is reimbursed under PPS, the limitation in 42 CFR 412.302(b)(1) applies. Subject to that limitation for PPS hospitals, the intermediary will reopen the cost reports as requested.

CORRECTED IMPLEMENTATION DATE--TRANSMITTAL 402

Section 108.1, Acquisitions and Section 108.2, Betterments and Improvements**,** were revised by Transmittal 402 dated February 1998. The effective date of the changes in Transmittal 402 should be "**For Assets acquired on or after March 30, 1998.**"

DISCLAIMER: The revision date and transmittal number only apply to the redlined material. All other material was previously published in the manual and is only being reprinted.

These instructions should be implemented within your current operating budget.

100. GENERAL

The principles of reimbursement for provider costs provide that payment for services should include depreciation on all depreciable type assets that are used to provide covered services to beneficiaries. This includes assets that may have been fully (or partially) depreciated on the books of the provider but are in use at the time the provider enters the program. The useful lives of such assets are considered not to have ended and depreciation calculated on a revised extended useful life is allowable. Likewise, a depreciation allowance is permitted on assets that are used in a normal standby or emergency capacity.

The three methods of prorating the cost of depreciable assets are: straight line, declining balance, and sum of the years' digits. For assets acquired after July 1970, however, the use of an accelerated method of depreciation is limited to a declining balance method not to exceed 150 percent of the straight-line rate under the criteria stated in §116C. The depreciation method used under the Medicare program for an asset need not correspond to the method used by a provider for non-Medicare purposes.

102. PRINCIPLES

An appropriate allowance for depreciation on buildings and equipment is an allowable cost. The depreciation must be: (a) identifiable and recorded in the provider's accounting records; (b) based on the historical cost of the asset as defined in §104.10 or, in the case of donated assets, the lesser of the fair market value or the net book value at the time of donation (see §114.2); and (c) prorated over the estimated useful life of the asset using an allowable method of depreciation as described in §116.

Depreciation on assets being used by a provider at the time it enters into the title XVIII program is allowed. This applies even though such assets may be fully or partially depreciated on the provider's books.

For all assets acquired before 1966, the provider, at its option, may choose an allowance for depreciation based on a percentage of operating costs. The operating costs to be used are the lower of the provider's 1965 operating costs or the provider's current year's allowable costs. The percent to be applied is 5 percent starting with the year 1966-67, with such percentage being uniformly reduced by one-half percent each succeeding year. The allowance based on operating costs is in addition to a regular depreciation on assets acquired after 1965. However, when the optional allowance is selected, the combined amount of such allowance on pre-1966 assets and the straight-line depreciation on assets acquired or rented after 1965 may not exceed 6 percent of the provider's allowable cost for the current year.

Depreciation is allowed on assets financed with Hill-Burton or other Federal or public funds.

104. DEFINITIONS

Depreciation is that amount which represents a portion of the depreciable asset's cost or other basis which is allocable to a period of operation. The amount of depreciation is determined by the provider's method of depreciation accounting.

The American Institute of Certified Public Accountants defines depreciation as a process of cost allocation:

"Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year."

104.1 Depreciable Assets.--Assets that a provider has an economic interest in through ownership (regardless of the manner in which they were acquired) are subject to depreciation. Generally, depreciation is allowable on the assets described below when required in the regular course of providing patient care. Assets which a provider is using under a regular lease arrangement would not be subject to depreciation by the provider. (See §110 on lease-purchase and sale-lease-back agreements.)

In general, assets subject to depreciation are described in the AHA Chart of Accounts for Hospitals, M-58, 15M-8/66-183305, and for the most part are also subject to depreciation for Medicare purposes. However, see the treatment of minor equipment as described below.

104.2 Buildings.--Building includes, in a restrictive sense, the basic structure or shell and additions thereto. The remainder is identified as building equipment.

104.3 Building Equipment.--Building equipment includes attachments to buildings, such as wiring, electrical fixtures, plumbing, elevators, heating system, air conditioning system, etc. The general characteristics of this equipment are: (a) affixed to the building, and not subject to transfer; and (b) a fairly long life, but shorter than the life of the building to which affixed. Since the useful lives of such equipment are shorter than those of the buildings, the equipment may be separated from building cost and depreciated over this shorter useful life.

104.4 Major Moveable Equipment.--The general characteristics of this equipment are: (a) a relatively fixed location in the building; (b) capable of being moved as distinguished from building equipment; (c) a unit cost sufficient to justify ledger control; (d) sufficient size and identity to make control feasible by means of identification tags; and (e) a minimum life of approximately three years. Major moveable equipment includes such items as accounting machines, beds, wheelchairs, desks, vehicles, x-ray machines, etc.

104.5 Minor Equipment.--The general characteristics of this equipment are: (a) in general, no fixed location and subject to use by various departments of the provider's facility; (b) comparatively small in size and unit cost; (c) subject to inventory control; (d) fairly large quantity in use; and, (e) generally, a useful life of approximately 3 years or less. Minor equipment includes such items as waste baskets, bed pans, syringes, catheters, silverware, mops, buckets, etc.

104.6 Land (Non-Depreciable).--Land (non-depreciable) includes the land owned and used in provider operations. Included in the cost of land are the costs of such items as off-site sewer and water lines, public utility charges necessary to service the land, governmental assessments for street paving and sewers, the cost of permanent roadways and grading of a non-depreciable nature, the cost of curbs and sidewalks whose replacement is not the responsibility of the provider, and other land expenditures of a non-depreciable nature. Although land used in the provision of patient care activities is a capital asset, the cost of which is neither depreciable nor amortizable under any circumstances, the historical cost limitations described in §104.10 apply to the valuation of land for purposes of determining allowable interest expense under §§202.1 and 203 and return on equity capital under §§1202.1 and 1218.12 (if applicable).

104.7 Land Improvements (Depreciable).--Depreciable land improvements include paving, tunnels, underpasses, on-site sewer and water lines, parking lots, shrubbery, fences, walls, etc. (if replacement is the responsibility of the provider).

104.8 Leasehold Improvements.--Leasehold improvements include betterments and additions made by the lessee to the leased property. Such improvements become the property of the lessor after the expiration of the lease.

104.9 Accounting Records.--The depreciation allowance, to be acceptable, must be adequately supported by the provider's accounting records. For Medicare purposes, a provider may maintain supplementary records apart from formal records, but in a manner similar to that used in maintaining formal records. Appropriate recording of depreciation requires the identification of the depreciable assets in use, the assets' historical costs (or fair market value or net book value, as appropriate, at the time of donation in the case of donated assets (see §114.2)), the assets' dates of acquisition, the method of depreciation, estimated useful lives, and the assets' accumulated depreciation.

104.10 Historical Cost. --

A. General--Historical cost is the cost incurred by the present owner in acquiring the asset and preparing it for use. Generally such cost includes costs that are capitalized under generally accepted accounting principles. For example, in addition to the purchase price, historical cost includes architectural fees, consulting fees, and related legal fees.

When an appraisal of a proprietary provider's depreciable assets is necessary because its property records do not adequately reflect the cost of the facility, the cost based on the appraisal may not exceed the capitalized cost basis of the asset used for Federal income tax purposes. However, when a provider has elected for Federal income tax purposes to expense certain items, e.g., taxes and some carrying charges (such as interest), the historical cost basis for Medicare purposes may include the amount of these expensed items unless excluded under subsection C. Subsection C describes the limitations on the historical cost of assets acquired by hospitals or SNFs on or after July 18, 1984 and before December 1, 1997. Subsection E describes the limitations on the historical cost of assets acquired by all providers on or after December 1, 1997.

For the limitation on the inclusion of settlement costs in the historical cost of assets acquired by hospitals or SNFs on or after July 18, 1984, and for all providers on or after December 1, 1997, see subsections C and E. (See §134.3 for further information on asset values of proprietary providers.)

B. For Depreciable Assets Acquired By All Providers After July 1970 and Before December 1, 1997 and By Hospitals or SNFs Before July 18, 1984.--The historical cost must not exceed the lowest of:

- The acquisition cost of the asset to the new owner,
- The current reproduction cost adjusted for straight-line depreciation over the life of the asset to the time of the purchase, or
- The fair market value at the time of the purchase. (See §104.14.)

C. For Depreciable Assets Acquired By Hospitals or SNFs On or After July 18, 1984 and before December 1, 1997.--The historical cost shall not exceed the lowest of the following:

- o The allowable acquisition cost for Medicare purposes 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);

- o The acquisition cost of the asset to the new owner; or

- o The fair market value of the asset on the date of acquisition.

NOTE: If the acquisition was subject to an enforceable agreement entered into before July 18, 1984, the limitations in subsection B apply.

For the purpose of determining the limitation on historical cost for assets acquired by hospitals and SNFs on or after July 18, 1984:

1. An asset not in existence as of July 18, 1984, includes any asset that physically existed, but was not owned by a hospital or SNF participating in the Medicare program as of July 18, 1984.

2. The acquisition cost to the owner of record is subject to any limitation on historical cost described in subsections A and B above and is not reduced by any depreciation taken by the owner of record.

3. The acquisition cost to the owner of record includes the costs of betterments or improvements that extend the estimated useful life, increase productivity, or significantly improve the safety of an asset. (See §108.2.)

4. The acquisition cost to the owner of record for assets acquired prior to a hospital's or SNF's entry into the Medicare program is the historical cost of the asset when acquired, rather than when the hospital or SNF entered the program.

5. The acquisition cost to the owner of record for assets subject to the optional allowance for depreciation described in §124 is the historical cost established for those assets when the hospital or SNF changed to actual depreciation as described in §126. If the hospital or SNF did not change to actual depreciation as described in §126 for optional allowance assets, the acquisition cost to the owner of record is established by reference to the hospital's or SNF's recorded historical cost of the asset when acquired. If the hospital or SNF has no historical cost records for optional allowance assets, the acquisition cost to the owner of record is established by appraisal.

6. The historical cost of an asset acquired on or after July 18, 1984, may not include costs attributable to the negotiation and 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. If payment was made for even one cost of this type, all costs of this type must be excluded from the historical cost. (Neither may such costs be included in allowable costs as period costs.) The costs to be excluded include, but are not limited to, appraisal costs (except those incurred at the request of the intermediary under §132.A.1), legal fees, accounting and administrative costs, travel costs, and the costs of feasibility studies. If payment was made for even one cost of this type, all costs of this type must be excluded from the historical cost and are not otherwise allowable.

EXAMPLE 1: An SNF was constructed in January 1987 at a cost of $15 million and approved for Medicare participation. It was sold in 1992 for $20 million. Its fair market value was $20 million. The allowable acquisition cost to the new owner is $15 million.

EXAMPLE 2: Hospital XYZ was constructed in 1980. At the time of construction, the provider also incurred costs for architectural fees and for legal fees. These costs were capitalized and reimbursed as depreciation.

In January 1985, the facility was sold. The purchaser incurred costs for a feasibility study, appraisal fees, and accounting fees related to the purchase. Because fees related to the acquisition of the asset were previously reimbursed under the Medicare program, the purchaser may not include any of the fees attributable to the sale (the cost of the feasibility study, the appraisal fees, and the accounting fees) in the historical cost of the asset nor can the purchaser include these costs as period costs.

EXAMPLE 3: A hospital was built at a cost of $10 million and began operation in October 1986. It did not participate in the Medicare program. In May 1993, it was sold for $12 million, its fair market value, and approved for Medicare participation. Because the hospital had never participated in the program, the allowable acquisition cost to the new owner for Medicare purposes is $12 million.

EXAMPLE 4: The facts are the same as above except the new owner operated the hospital as a nonparticipating hospital until May 1995. At that time, it was approved for Medicare participation. The acquisition cost is $12 million. The basis for depreciation is the acquisition cost reduced by the depreciation accumulated up to the date of entrance into the program. (See §114.B.)

EXAMPLE 5: A nursing facility was constructed in 1983 for $3 million and has operated since that time as a Medicare approved nursing facility. The facility was purchased in 1992 for $8 million. The purchase was entirely financed with a mortgage. The fair market value at the time of sale was $8 million. As a result of §1861(v)(1)(O) of the Act (§2314(a) of DEFRA), the cost basis in the assets was limited to $3 million. Since the purchase in 1992, the nursing facility has allowed accumulated depreciation of $600,000.

In 1994, the nursing facility was sold to an unrelated party for a down payment of $10,000 and the assumption of the facility's outstanding debt of $8 million. The gain or loss is determined as follows:

Actual sales proceeds	$8,010,000
Net book value determined under §1861(v)(1)(O)*	-$2,400,000
Gain on sale	$5,610,000

* $3 million less $600,000

The result of the transaction is a gain of $5,610,000 on the sale (sales price of $8,010,000 less the net book value under §1861(v)(1)(O) of $2,400,000). The maximum amount of the gain recognized by Medicare is limited to the depreciation previously included in Medicare allowable cost, or $600,000. Since $600,000 is less than the total gain of $5,610,000, the total depreciation taken would be includable in the Medicare cost report as a gain. Had there been a loss on the transaction, the amount of the loss would be limited to $2,400,000, the undepreciated basis of the asset permitted under the program ($3,000,000 minus $600,000).

NOTE: The allowable acquisition cost for the new owner (the 1994 purchaser) is $3 million. For the new owner, interest expense is allowable on only $2,990,000 of the $8 million loan assumed. As described in §203, in determining the amount of the loan on which interest expense is allowable, one looks first to the allowable cost of the facility for program purposes (which in this case is $3 million). From this amount, the owner's investment is subtracted, and the balance is the amount on which interest expense is allowable.

EXAMPLE 6: Tom owns a hospital, which he bought for $1 million in 1980. In 1985, he made improvements of $250,000 which extended the useful life of the building.

In 1990, Tom sells the hospital to Dick for $1.1 million. At this point, the historical cost for Dick would be $1.1 million, the lowest of:

o 1.25 million which is the original cost to Tom plus the $250,000 in improvements;

o $1.1 million purchase price; or

o The fair market value which is at least $1.1 million.

Dick finds that he needs to make improvements before opening for business and spends $500,000. In 1992, Dick sells the hospital to Harry for $2 million. The historical cost to Harry would be $1.25 million, the lowest of:

o $1.25 million, the original cost to Tom plus the $250,000 in improvements made by Tom;

o $2 million purchase price; or

o The fair market value which is at least $2 million.

D. Hospital-Based Providers Other Than SNFs and SNF-Based Providers.--For changes of ownership before December 1, 1997 that involve assets of a hospital-based provider other than an SNF, or assets of an SNF-based provider, the provisions of subsection C are not applicable. A reasonable allocation of the purchase price must be made so the hospital-based provider other than an SNF, or an SNF-based provider is not affected by the limitations described above. The historical cost of providers other than hospitals and SNFs is governed by subsection B.

E. For Depreciable Assets Acquired By All Providers On or After December 1, 1997. -- The historical cost of the asset to the acquirer will be the historical cost less depreciation allowed to the owner of record as of August 5, 1997 (or if an asset did not exist as of August 5, 1997, the first owner of record after August 5, 1997). The asset moves from the hands of the seller to the hands of the buyer at the assets's net book value defined in §104.23. For purposes of this section, the following apply:

1. An asset that was not in existence as of August 5, 1997 includes an asset that physically existed but was not owned by a provider participating in the Medicare program as of that date.

2. The historical cost to the owner of record is subject to the limitation on historical costs described in section B through D of this section, and is reduced by any depreciation taken by the owner of record. The limitation on historical cost is also applied to the purchase of land, which is a capital asset that is neither depreciable nor amortizable under any circumstances. (See §§200ff for application of the limitation to the cost of land for purposes of determining the allowable interest expense.)

3. Historical cost to the owner of record includes the costs of betterments or improvements that extend the estimated useful life, increase the productivity, or significantly improve the safety of an asset. (See §108.2.)

4. For assets acquired prior to a provider's entrance into the Medicare program, the historical cost to the owner of record is the historical cost when acquired, rather than when the provider entered the program.

5. For assets subject to the optional depreciation allowance as described in §413.139, the historical cost to the owner of record is the historical cost established for those assets when the provider changed to actual depreciation as described in §124. If the provider did not change to actual depreciation, as described in §126, for optional allowance assets, the historical cost to the owner of record is based on the provider's recorded historical cost of the asset when acquired. If the provider has no historical cost records for optional allowance assets, the historical cost to the owner of record is established by appraisal.

6. The historical cost of an asset acquired by hospitals and SNFs on or after July 18, 1984 and by all providers on or after December 1, 1997 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 §132.A.1), legal fees, accounting and administrative costs, travel costs, and the costs of feasibility studies. If payment was made for even one cost of this type, all costs of this type must be excluded from the historical cost and are not otherwise allowable.

NOTE: The change in §1861(v)(1)(O) of the Act as amended by §4404 of the Balanced Budget Act (Pub. L. 105-33) has no effect on the recovery of accelerated depreciation as described in §136.

EXAMPLE 1: An SNF was constructed in 1990 for $25 million by Walter and certified for Medicare participation. It was sold in 1995 for $30 million to Ed. Because of the limitations in C. above, the allowable acquisition cost to Ed is $25 million. Ed sells the SNF in 1998 for $30 million to Zelda. Zelda financed the transaction with $5 M in cash and $25 M in bonds. The limitation on the selling price is determined as follows:

Historical Cost to Ed	$25 million
Salvage Value	$ 1 million
Estimated useful life	32 years
Depreciation	
$25 M - $1 M = $24 M	
$24 M ÷ 32 =	$750,000 per year
Depreciation claimed	$2, 250,000
Net Book Value on Ed's books	$22,750,000

There will be no gain or loss on the transaction to Ed. The historical cost to Zelda is $22,750,000. Zelda's allowable interest expense will be limited to the interest on $22,750,000, less the $5,000,000 paid in cash, or $17,750,000.

EXAMPLE 2: In 1995 Mary buys an SNF for $55 million from Peter who has owned and operated it under the Medicare program since it was built in 1990. The SNF cost $50 million to build and its net book value on Pete's books is $45 million. The allowable acquisition costs to Mary is $50 million. Mary continues to operate it as a Medicare provider and depreciates it at $1,250,000 a year.

In 1998 Mary converts it to a noncertified nursing home. At that time her net book value is $46,250,000. She operates it as such until 1999. She sells it to Paul at the end of 1999 for $55 million. Her net book value at the date of sale is $45 million. Paul has it certified for Medicare participation in 2000. Paul's basis is $45 million, less depreciation taken since his date of purchase.

EXAMPLE 3: In 1990, Sam builds a hospital at the cost of $14 million. He operates it as a nonparticipating hospital until 1998. At that time he sells it for $18 million to Melvin. Melvin makes improvements totaling $3 million and the hospital is certified for Medicare participation in 1999. In 2001 he sells the hospital to Hal for $30 million. The net book value on Melvin's books is $18.4 million. There is no gain or loss on the sale. The historical cost to Hal is $18.4 million.

EXAMPLE 4: Michael buys a SNF in 1983 for $20 million. He operates it as a Medicare certified facility until 1999, at which time he sells it to Warren for $6 million. The net book value at the date of sale is $9 million. There is no gain or loss on the sale. The historical cost to Warren is $9 million.

104.11 Historical Cost - Trade-Ins.--When an asset is acquired by trading-in an asset that was depreciated under the program, the cost of the new asset is the sum of the undepreciated cost (or fair market value if no cost is assigned) of the asset traded-in and any cash or other assets transferred or to be transferred to acquire the new asset. However, if the asset disposed of was acquired by the provider before its participation in the Medicare program and the sum of the undepreciated cost and the cash or other assets transferred or to be transferred exceeds the list price or fair market value of the new asset, the historical cost of the new asset is limited to the lower of its list price or fair market value.

For assets having no historical or appraisal values assigned, the cost basis is the fair market value at the date of disposal of the old asset plus the sum paid but not to exceed the lower of the list price or fair market value of the new asset.

104.12 Appraisals.--For Medicare purposes, the term "appraisal" refers primarily to the process of establishing or reconstructing the historical cost, fair market value or current reproduction cost of an asset. It includes a systematic, analytic determination and the recording and analyzing of property facts, rights, investments, and values based on a personal inspection and inventory of the property. (See §§134ff.)

A. Appraisal Date.--The date selected for establishing the value of fixed assets is called the appraisal date. For example, if December 31, 1967, was established as the appraisal date and the actual physical inventory of fixed assets was taken in February 1968, any additions or dispositions of fixed assets between December 1967 and February 1968 must be taken into account in the appraisal values.

B. Appraised Book Value.--The book value of an asset at the appraisal date is its appraised cost as of the date of acquisition less accumulated depreciation computed on any approved basis up to the appraisal date.

C. Appraisal Expert.--An appraisal expert means an individual or a firm that is experience and specialized in multi-purpose appraisal of plant assets involving the establishing or reconstructing of the historical cost, fair market value, or current reproduction cost of such assets; employs a specially trained and well supervised staff with a complete range of appraisal and cost construction techniques; is experienced in appraisals of plant assets used by providers; and demonstrates a knowledge and understanding of the regulations involving reimbursement principles, particularly those pertinent to depreciation.

104.13 Lease-Purchase Assets.--If a lease is a virtual purchase as described in §110.B and the lessee becomes the owner of the leased asset, the historical cost of the asset is the sum of the deferred charge (the difference between the amount of the rent paid and the amount of rent allowed as rental expense) and any additional payments made to acquire the assets, subject to the limitation on revaluation of assets. (See §110.B.2.)

104.14 Purchase of Facility as Ongoing Operation.--

A. The historical cost of assets when an ongoing facility is purchased through a bona fide sale is determined as follows:

1. For depreciable assets acquired after July 1, 1966, and prior to August 1970, the sale price or portion thereof attributable to the asset must not exceed the fair market value of the asset at the time of the sale.

2. For depreciable assets acquired after July 1970 and in the case of hospitals and SNFs, before July 18, 1984, the historical cost must not exceed the lowest of (1) the acquisition cost of the asset to the new owner, (2) the current reproduction cost adjusted for straight-line depreciation over the life of the asset to the time of the purchase, or (3) the fair market value at the time of the purchase. (See §104.15.)

3. For depreciable assets acquired by hospitals or SNFs on or after July 18, 1984, and not subject to an enforceable agreement, the limitations on historical cost specified in §104.10.C are applicable.

4. For depreciable assets acquired by all providers on or after December 1, 1997, the limitations on historical cost specified in §104.10.E are applicable.

B. For changes of ownership on or after December 1, 1997, no gain or loss is recognized on the sale. For changes of ownership before December 1, 1997, the basis for determining the gain or loss to the seller when the facility was being operated under the program at the time of sale is the sales price.

For assets acquired prior to July 1970, the sale price used by the seller in computing gain or loss for the final cost report must agree with the historical cost used by the new provider in computing depreciation.

For an asset acquired after July 1970, the basis for computing gain or loss to the seller is the sales price without regard to any limitation on the basis for depreciation to the buyer as described in §104.10. (See example 5 in §104.10.C.)

The gain or loss on the sale of each depreciable asset must be determined by allocating the lump sum sale price among all the assets sold (including land, goodwill, and any assets not related to patient care), 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 sale 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 must require an appraisal by an independent appraisal expert to establish the fair market value of each asset and must make an allocation of the sale price in accordance with the appraisal. (See §§134ff.) In any case, the sale price must be allocated among all the assets sold, even when, for example, some of the assets will be disposed of shortly after the sale.

C. If a purchaser cannot demonstrate that the sale was bona fide, the seller's net book value must be used by the purchaser as the basis for depreciation of the asset. In such a case, the purchaser must record the historical cost and accumulated depreciation of the seller recognized under the program, and these are considered as incurred by the purchaser for program purposes, such as application of §§132ff. (See §1011.4 if related organizations are involved.)

104.15 Fair Market Value.--Fair market value is the price that the asset would bring by bona fide bargaining between well-informed and unrelated buyers and sellers at the date of acquisition. Usually the fair market is the price at which bona fide sales have been consummated for assets of like type, quality, and quantity in a particular market at the time of acquisition.

104.16 Donated Assets.--An asset is considered donated when the provider acquires the asset without making any payment for it in the form of cash, property, or services. When the provider makes any such payment in acquiring the asset, if the payment is less than the fair market value, then this payment, and not the fair market value, is considered to be the historical cost of the asset. If an asset is exchanged for new debt or the assumption of debt, then the transaction is considered a sale and not a donation. (For the depreciation basis, see §114.2.)

104.17 Useful Life of Depreciable Assets.--The estimated useful life of an asset is its expected useful life to the provider, not necessarily the inherent useful or physical life. In initially selecting a proper useful life for computing depreciation under the Medicare program, the provider may use certain published useful life guidelines. The guidelines used depend on when the asset was acquired. For assets acquired before January 1, 1981, either the Internal Revenue Service (IRS) or the American Hospital Association (AHA) guidelines may be used. For assets acquired on or after January 1, 1981, only the AHA guidelines may be used.

Date Asset Acquired	Useful Life Guidelines
Before 1/1/81	Internal Revenue Service (IRS) guidelines except those offered by the Asset Depreciation Range System) or the 1973 edition of the AHA Chart of Accounts for Hospitals
On or after 1/1/81, but before 1/1/82	1973 edition of the AHA Chart of Accounts for Hospitals
On or after 1/1/82, but before 1/1/83	1978 edition of the AHA Estimated Useful Lives of Depreciable Hospital Assets
On or after 1/1/83, but before 8/1/88	1983 edition of the AHA Estimated Useful Lives of Depreciable Hospital Assets
On or after 8/1/88, but before 3/1/93	1988 edition of the AHA Estimated Useful Lives of Depreciable Hospital Assets (except Table I)
On or after 3/1/93 but before 3/1/98	1993 edition of the AHA Estimated Useful Lives of Depreciable Hospital Assets
On or after 3/1/98	1998 edition of the AHA Estimated Useful Lives of Depreciable Hospital Assets

The use of the 1978 or later AHA editions allow more detailed component lives for building and building equipment (e.g., automatic doors, canopies, computer flooring, etc.). Each component may be depreciated separately on the basis of the useful life of each component, rather than on the basis of a single useful life for the entire building.

A composite useful life, as illustrated in the 1973 and 1978 editions, may be used for a class or group of assets. In using the 1988 edition, Table 1, which provides useful life ranges for groups of assets, may not be used.

For assets acquired before December 1, 1997, a purchaser of a used asset must assume a useful life based on the guidelines for new assets. However, if approved by the intermediary, the purchaser of a used asset may reduce the useful life based on acceptable factors that affect the establishment of a different useful life as described below. For used assets acquired on or after December 1, 1997, and subject to the historical cost limitation in 104.10E and 104.14A.4 the purchaser must use the remaining useful life .

Purchased computer software acquired prior to August 1, 1988, is depreciated over the useful life of the hardware if the software is purchased with computer equipment and the cost is not separately stated. If the cost of the software is separately stated, or if the software is purchased independent of the hardware, it must be depreciated over a minimum of 5 years. Purchased computer software purchased on or after August 1, 1988, is depreciated using the applicable edition of the useful life guidelines.

The costs of initial customizing and/or modification of purchased computer software to function with the provider's computer hardware, or to put it into place for use, should be capitalized as part of the historical cost of the software. Such costs are analogous to installation costs of a moveable asset. The costs of internally generated computer software must be expensed, rather than capitalized. For purposes of this section, internally generated computer software means software generated, in whole or in part, by staff internal to the provider. The use of outside consultants to assist the provider's staff in developing a systems change does not change the nature of any resultant software from internally generated to purchased.

The costs of a building addition may be depreciated over the remaining useful life of the primary building to which it is appended, rather than over the inherent physical life of the building addition, if the provider intends to demolish or abandon the primary building and the building addition upon the expiration of the useful life of the primary building. However, the provider must demonstrate to the intermediary by convincing evidence a clear intention to demolish or abandon the building addition at the expiration of the useful life of the primary building (e.g., a master building plan which does not provide for any alternative which would have the building addition remain in place beyond demolition or abandonment of the primary building). If the provider's evidence contains alternatives that would extend the useful life of the building addition beyond the remaining useful life of the primary building, a presumption must be made that the useful life of the building addition corresponds with its inherent physical life, and the shorter useful life may not be used.

A different useful life may be approved by the intermediary if the provider's request is properly supported by acceptable factors which affect the determination of useful life. Such factors include normal wear and tear, obsolescence due to normal economic and technological changes, climatic and other local conditions, and the provider's policy for repairs and replacement. When the useful life selected differs significantly from that established by the guidelines, the deviation must be based on convincing reasons supported by adequate documentation, generally describing the realization of some unexpected event. Factors such as an expected early sale, retirement, demolition, or abandonment of an asset (however, see exception regarding building additions above), or termination from the Medicare program, may not enter into a determination of the expected useful life of an asset.

104.18 Useful Life - Leasehold Improvements.--The costs of improvements which are the responsibility of the provider under the terms of a lease may be depreciated over the useful life of the improvement or the remaining term of the lease, whichever is shorter. The term of the lease includes any period for which the lease may be renewed, extended, or continued following either an option exercised by the provider or, in the absence of an option, reasonable interpretation of past acts of the lessor and lessee pertaining to renewal, etc., unless the provider establishes, omitting past acts, that it will probably not renew, extend, or continue the lease.

104.19 Salvage Value - Depreciable Assets.--Salvage value is the estimated amount expected to be realized upon the sale or other disposition of the depreciable asset when it is no longer useful to the provider. The amount is ordinarily estimated at the time of acquisition and, except for the declining balance method, is deducted from the cost of the depreciable property to arrive at the basis for depreciation. For example, an asset is purchased for $17,000 with an expected salvage value of $2,000. The basis for depreciation becomes $15,000 (i.e., $17,000 less $2,000) for computing the depreciation.

Thus, if a provider disposes of its assets when they are in good operating condition, the salvage value is higher than it might be if the provider used the assets until their inherent life had been substantially exhausted. Virtually all assets have a salvage value substantial enough to be included in calculating depreciation, and only in the rare instance is salvage value so negligible that it may be ignored.

For assets acquired on or after December 1, 1997, and subject to the historical cost limitation in 104.10E and 104.14A.4, salvage value need not be taken.

104.20 Scrapping.--Scrapping is the physical removal from the provider's premises of tangible personal property which is no longer useful for its intended purpose and is only salable for its scrap or junk value.

104.21 Abandonment.--Abandonment means the permanent retirement of an asset for any future purpose, not merely the provider's ceasing to use the asset for patient care purposes. To claim an abandonment under the program, the provider must have relinquished all rights, title, claim, and possession of the asset with the intention of never reclaiming it or resuming its ownership, possession, or enjoyment.

104.22 Demolition.--The deliberate destruction of a building or other asset resulting in the complete loss of economic value (other than the scrap value) of the asset.

104.23 Net Book Value.--The net book value of the asset is defined as the historical cost under the program less the depreciation recognized under the program.

104.24 Bona Fide Sale.--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 a transaction negotiated by unrelated parties, each acting in its own self interest.

106. METHODS FOR WRITING OFF COST OF MINOR EQUIPMENT

Except where prohibited by §108, a provider may treat the cost of the minor equipment needed to operate its facility in any one of the following methods:

(a) The original investment in this equipment is not amortized or depreciated. Any replacements to the base stock are charged to operating expenses. The investment in the base inventory of equipment is adjusted when there is a significant change in the inventory size. For example:

Provider Fiscal Year - July 1 to June 30

Provider Entered Program - July 1, 1966

Original Cost of Minor Equipment in Use at July 1, 1966 - $15,000

Purchases During FY July 1, 1966, to June 30, 1967 ------ $10,000

Minor Equipment Inventory Value at June 30, 1967 -------- $20,000
(Determined for this example to be a significant change in inventory size)

Charges to operating expense in FY ended June 30, 1967, are $5,000. (Purchases of $10,000 less increase in inventory value of $5,000)

(b) The net book value of such items at the time the provider enters the program may be written off ratably over 3 years; that is, one third of the net book value is written off each year. Net book value is the historical cost less previous write-off. The previous write-off should have been computed on the basis of not more than a 3-year life and in equal amounts. A full one-third write-off should have been made in the year of acquisition. If the computation had been based on longer life or a different rate, or both, or if the equipment has been previously written off directly through charges to operating expense, the net book value at the time the provider enters the program is amortized applying a 3-year basis. Thus, any asset over 3 years old, although still in use, is not included. Under this method, any new purchases are also written off ratably over a 3-year period. For example:

Provider Fiscal Year - January l to December 31

Provider Entered Program - January 1, 1967

Purchase Date	Acquisition Cost of Minor Equipment in Use on 1/1/67		Recomputed Write-Off To 1/1/67		Net Book Value As Of 1/1/67
1965	$9,000	minus	$6,000	equals	$3,000
1966	6,750	minus	2,250	equals	4,500
				Total	$7,500

Write-Off allowed on above equipment:
1967 - $2,500
1968 - $2,500
1969 - $2,500

of the section must be used in calculating the limitation on adjustments to depreciation for the purpose of determining any gain or loss upon disposal of an asset under §132.

e. If the provider undergoes a change of ownership (CHOW) during the lease period, and the lease is assigned to the new owner (with no changes to the lease terms), the deferred rental charge is treated as follows:

1. If the CHOW is between or among unrelated entities, any rental amount deferred as of the date of the CHOW is included in the terminating provider's final cost report. The acquiring provider must apply the above limitations in determining the amount of rental charges to be included in its allowable costs. EXCEPTION: If the terms of the lease changed in addition to the assignment of the lease, the new lease must be evaluated to determine if it should still be considered as lease-purchase agreement.

2. If the CHOW is between or among related organizations, the lease is treated as if a CHOW had not occurred (i.e., the deferred rental amount may not be included in the termination provider's final cost report, and the above limitations will continue to apply in determining the amount of rental expense that may be included in the allowable costs of the acquiring provider.

EXAMPLE: A provider leased the following asset for 5 years at a cost of $75,000 per year. The asset costs $300,000 and has a useful life of 6 years. The cost of ownership was determined as follows:

Cost	$300,000
Useful Life	6 years
Depreciation	$50,000 per year
Insurance	$ 3,000 per year
Interest	$12,000 per year

The yearly cost of ownership is $65,000. It was determined that this was a virtual purchase. The rental charge included in allowable expense is limited to $65,000 and the difference of $10,000 is deferred.

The asset is then purchased by the provider at the end of the lease for $30,000. The basis of the asset is $30,000 plus 5 years deferred charges at $10,000 or a total of $80,000. The useful life is 6 years and the salvage value is $2,000. The purchaser of a used asset must assume a useful life based on the guidelines for new assets unless a different useful life is justified to the intermediary. (See §104.17.)

The provider keeps the asset for 4 years and sells it for $35,000. The gain or loss on the sale is determined as follows:

Basis	$80,000
Depreciation	$52,000
Undepreciated Basis	$28,000
Sales Price	$35,000
Gain	$ 7,000

The maximum amount of the gain recognized by Medicare is limited to depreciation previously included in Medicare allowable cost or $52,000. Had there been a loss on the transaction, the amount of the loss would be limited to $28,000, the undepreciated basis of the asset permitted under the program.

3. Effect of Funded Depreciation.--When a provider which has funded depreciation available leases an asset and it is determined that the lease is a virtual purchase, the lease charge is recognized as described in subsection 2. However, in determining the cost of ownership for comparison to the cost of leasing, the provider must not include a factor representing imputed interest expense. Since the provider had funded depreciation available, it would not have incurred interest expense related to the purchase. While the implicit interest expense cannot be included in determining the limitation, it is not unallowable. Rather, the implicit interest is deferred as part of the excess of the lease payment over the costs of ownership when funded depreciation is available. The excess of any reasonable rental or lease charge over the costs of ownership is not disallowed. As described in subsection 2, this excess is deferred and either (1) reimbursed when the asset is returned to the lessor or (2) included in the historical cost basis of the asset when the asset is purchased by the lessee.

111. ASSUMPTION OF LEASE AT LESS THAN FAIR RENTAL VALUE

There are some situations in which a provider may obtain lease rights for less than fair rental value when, for example, a provider assumes an existing lease on a tangible asset(s) as part of the purchase of a group of assets, which includes the favorable lease. In such situations, the provider is actually paying to obtain the favorable lease. If the provider and the entity from which the lease is assumed are not related within the meaning of Chapter 10, and if the essential elements of the lease (e.g., lease payments, lease term, responsibilities of lessor and lessee) remain unchanged as a result of the lease assumption, the reasonable amount paid for purposes of obtaining the lease (in excess of the actual amount of rent which must be paid under the lease) may be ratably amortized over the life of the lease (excluding renewal periods) so long as the leased assets are used to render patient care. If the lease is terminated before the amortization period is completed, the unamortized amount may be included in allowable cost in the year of termination. The reasonable amount for purposes of obtaining the favorable lease must be documented as having been paid for the lease, and it must be shown that the amount of rent required under the lease plus the amount paid for purposes of obtaining the favorable lease does not exceed the fair rental value of the lease.

EXAMPLE: In 1985, Corporation A purchases the assets of Hospital B, a provider corporation not related to Corporation A within the meaning of Chapter 10. Corporation A continues operation of the hospital as a participating provider. The assets purchased include a hospital building, building equipment, major moveable equipment, land, and a lease on a storage building located on property adjacent to the hospital property. The storage building is used to store provider assets related to patient care. The storage building and the land upon which it is situated is owned by Partnership XYZ (lessor), an organization not related to either Corporation A or Corporation B within the meaning of Chapter 10.

In 1980, when the lease was originally negotiated between Partnership XYZ and Provider B, the lease provided for a reasonable first year rental amount to be increased no more than 5 percent per year. The term of the lease was 10 years and the lease was assignable. From 1980 through the date of the sale of the hospital to Corporation A, fair rental values for similar rental properties have increased at the rate of 8 percent per year.

Corporation A, in recognition of the fact that it is assuming a favorable lease (at less than fair rental value), paid an additional, reasonable amount to Hospital B for the favorable lease. The amount paid in recognition of the favorable lease is documented in the sales agreement. The additional amount paid for the favorable lease may be ratably amortized over the remaining life of the lease (5 years), so long as the building continues to be used for a purpose related to patient care.

112. ALLOWANCE FOR DEPRECIATION ON FACILITIES LEASED FOR NOMINAL AMOUNT

A considerable number of providers lease their facilities from municipalities at a nominal rental (usually for $1.00 per year) with the lease generally covering the useful life of the facility. Under most lease arrangements, the tenant (lessee) maintains the property and pays the cost of any improvement or addition to the facility. When such improvement or addition is made, the lessee may properly depreciate its cost. The depreciation allowance is includable in allowable cost. At the end of the lease, improvements and additions made by the lessee become the property of the lessor. However, in some instances, the lease agreement provides that title to any additions or improvements is to revert to the owner in the first year they are used. In such cases, the cost of any addition or improvement is similarly depreciated, and the depreciation allowance is also includable in allowable cost.

It is the general practice of the provider to include in its charges (and cost) an amount to cover depreciation on the leased facilities as distinguished from capital improvements made by the lessee. In recognition of this practice, most third parties that reimburse providers on the basis of cost allow depreciation (but not interest) on facilities that have been leased for a nominal rental. In view of this and since the lease arrangement in such cases generally contemplates the occupancy by the lessee for the period of the useful life of the facility, depreciation on the leased facility may be included in allowable cost under the conditions described below.

112.1 Analysis of Lease Arrangement.--Each case must be decided on its own merits for depreciation to be allowed. The lease must contemplate that the lessee will make any necessary improvements and properly maintain the facility. The lease may and frequently does cover the useful life of the asset. If not, however, as in the case of a year to year lease, such lease is examined closely to determine whether the renewal and other provisions of the lease contemplate that the provider will use the facility to the extent of its useful life. Where the intent and provisions of the year to year lease permit the provider to have the benefit of the useful life of the facility, such lease is treated, for depreciation purposes, in the same manner as a long-term lease that covers the useful life of the asset. The actions of the lessee and lessor in such cases should indicate that the intent of both parties is to continue the lease arrangements for the useful life of the asset. Of course, other facts are considered together with the past actions of the lessee and lessor in order to determine whether or not the asset will and can be used by the lessee for the asset's full useful life.

The lease should have no restrictions on the free use of the facility by the lessee. In addition, the lease should not provide for any indirect benefits to the lessor or to those connected with the lessor. For example, if the lease requires that the lessee furnish free hospital services to the employees of the lessor, then depreciation is not allowed. In such case, the cost of the services furnished to the lessor's employees is appropriately included when determining Medicare's share of allowable costs.

When the provider pays or contributes to the lessor any funds which are to be used for retiring the lessor's bonds or notes issued for the facility, such payments are considered rental payments. These rental payments, to the extent they are reasonable, are considered an allowable cost. Also, any general contribution by the lessee to the lessor is considered a rental payment for the use of the facility. When either of such rental payments is allowable as cost, depreciation on the leased facility is not an allowable cost item.

114.1 Transfer of Governmental Facilities.--

A. Intergovernmental Transfer of Facilities.--When assets are transferred from one governmental entity to another under appropriate legal authority, the basis for depreciation is determined as follows.

1. Bona Fide Sale.--The basis for depreciation in a bona fide sale is the historical cost subject to the following limitations.

a. For assets acquired by other than hospitals or SNFs after 1970 and before December 1, 1997, or for assets acquired by hospitals or SNFs after 1970 and before July 18, 1984, the historical cost incurred by the present owner in acquiring the asset under a bona fide sale must not exceed the lower of:

(1) The current reproduction cost adjusted for straight-line depreciation over the life of the asset to the time of the purchase; or

(2) Fair market value at the time of the purchase.

b. For assets acquired by hospitals or SNFs on or after July 18, 1984 (see §104.10.C) and before December 1, 1997, the historical cost cannot exceed the lower of:

(1) The allowable acquisition cost, for Medicare purposes, 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.

c. For assets acquired by all providers on or after December 1, 1997, the allowable acquisition cost to the acquirer will be the historical cost less depreciation allowed to the owner of record as of August 5, 1997. (See §104.10.E.)

2. Donation.--An asset is considered donated when a governmental entity acquires the asset without assuming the functions for which the transferor used the asset or without making any payment for it in the form of cash, property, or services. To determine the basis for depreciation of a donated asset, see §114.2.

3. If neither items 1 or 2 above applies, i.e., the transfer was solely to facilitate administration or to reallocate jurisdictional responsibility, or the transfer constituted a taking over in whole or in part of the function of one governmental entity by another governmental entity, the basis for depreciation is:

a. For an asset on which the transferor has claimed depreciation under the Medicare program, the transferor's basis under the Medicare program prior to the transfer. The method of depreciation used by the transferee may be the same as that used by the transferor, or the transferee may change the method. (Beginning August l, 1970, a provider may only change from an accelerated method or optional method to the straight-line method. See §120.)

b. For an asset on which the transferor has not claimed depreciation under the Medicare program, the cost incurred by the transferor in acquiring the asset (not to exceed the basis that would have been recognized had the transferor participated in Medicare program) less depreciation calculated on the straight-line basis over the life of the asset to the time of transfer.

B. Transfer of State Hospital to Nonprofit Corporation Without Monetary Consideration.--If a State transfers a hospital to a nonprofit corporation without monetary consideration on or after July 18, 1984, the depreciable basis of the assets to the new owner is the net book value of the assets as recorded on the State's books at the time of the transfer. For the purpose of this section, monetary consideration includes cash, new debt, and assumed debt.

114.2 Assets Donated to Provider.--Where an asset is donated to a provider as described in §104.16, the basis for depreciation is determined as follows.

1. Assets Not Used or Depreciated Under Medicare Program.--If an asset has never been used or depreciated under the Medicare program and is donated to a provider, the basis for the purpose of calculating depreciation and equity capital (if applicable) is the fair market value of the asset (see §104.15) at the time of donation.

2. Assets Used or Depreciated Under Medicare Program--If an asset has been used or depreciated under the Medicare program and is donated to a provider or when a provider acquires such assets through estate or intestate distribution, e.g., a widow inherits a skilled nursing facility upon the death of her husband and becomes the owner of a newly certified provider, the basis for the purpose of calculating depreciation and equity capital (if applicable) is:

a. The fair market value at the time of donation; or

b. The net book value in the hands of the owner last participating in the Medicare program.

For donated assets, the basis for depreciation is determined as of the date of donation or the date of death, whichever is applicable. See §104.23 for determining net book value and §104.16 for determining fair market value of donated assets.

When the provider's records do not contain the fair market value of the donated assets as of the date of donation, an appraisal of such fair market value by a recognized appraisal expert is acceptable for depreciation and owner's equity capital purposes.

The provider furnishes its intermediary with information identifying the appraisal expert and type and method of appraisal to be used. The intermediary determines whether the contemplated appraisal is acceptable. (See §§134ff.)

130. DISPOSAL OF ASSETS

Depreciable assets may be disposed of through sale, scrapping, trade-in, donation, exchange, demolition, abandonment or involuntary conversions such as condemnation, fire, theft or other casualty. If the disposal of a depreciable asset results in a gain or loss, an adjustment may be necessary in the provider's allowable cost (see §104.10.B through §104.10.E.). The amount of gain included in the determination of allowable cost is limited to the amount of depreciation previously included in allowable costs. The amount of loss to be included is limited to the undepreciated basis of the asset permitted under the program. When an asset has been retired from active service but is being held for standby or emergency services, depreciation may continue to be taken on such assets. In no case, however, can gain or loss be computed on the retired asset until the asset is actually disposed of. A gain or loss on the disposal of depreciable assets has no effect on a proprietary provider's equity capital for prior years. If the sale or scrapping occurs on or after December 1, 1997, no gain or loss is recognized (see §104.10.E).

132. GAINS AND LOSSES ON DISPOSAL OF DEPRECIABLE ASSETS (EXCLUDING INVOLUNTARY CONVERSIONS)

A. Gains and losses on the disposition of depreciable assets are includable, as applicable, either in computing allowable cost or in computing the adjustment to Medicare reimbursable cost, depending upon the manner of disposition of the asset, the date of the disposal, and the amount of the net depreciation adjustment. Any type of asset may be disposed of by sale. Scrapping, as defined in §104.19, however, is limited to tangible personal properties which (1) can be physically removed from the provider's premises, (2) are no longer useful for their intended purpose, and (3) are only salable for their scrap or junk value. Structures such as buildings which cannot easily be moved are usually demolished or abandoned when useless. However, certain building components such as doors, fixtures and elevators that can be detached from the building shell can be either demolished or scrapped. The manner of disposition is the criterion, not the asset type.

1. Bona Fide Sale or Scrapping.--Gains and losses realized from a bona fide sale or scrapping of a depreciable asset before December 1, 1997 are includable as an adjustment of depreciation in the period of disposal under the criteria in §132.3.A, or if those criteria are not met, includable as an adjustment to Medicare reimbursable costs under §132.3.B. or C. based on an allocation of the gains and losses to periods during which depreciation was allowed under the program for the disposed assets. Gains and losses may be recognized on a bona fide sale before December 1, 1997 which occurs while the provider is either participating in the program or within 1 year immediately following the date on which the provider terminates participation in the Medicare program. However, gains and losses are recognized only on a scrapping before December 1, 1997, that occurs while the provider is participating in the program. If several assets are sold 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 on the basis of the fair market value of each asset 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 shall require an appraisal by an independent appraisal expert to establish the fair market value of each asset and shall make an allocation of the sales price in accordance with the appraisal.

EXAMPLE 2: Computation of Net Depreciation Adjustment Where Straight Line Depreciation Was Claimed by the Provider.

Historical cost - 7/1/67	$490,000
Actual salvage value - sales price - 12/31/73	300,000
Basis for depreciation	$190,000

Depreciation taken - straight-line method	
$465,000 ÷ 30 (years) = $15,500 per year x 6 ½ years =	$100,750
Basis for depreciation	190,000
Net depreciation adjustment - additional depreciation allowed the provider	($ 89,250)

EXAMPLE 3: Computation of Net Depreciation Adjustment Applicable Where a Provider Claimed Accelerated Depreciation, Terminates Participation in the Program After July 1970, and Disposes of its Depreciable Assets.

Computation of Depreciation in Excess of Straight-Line Depreciation

Depreciation taken-sum-of-the-years' digits method	
$465,000 ÷ 465 units (30 years) = $1,000 per unit	
$1,000 x 177 units (6 ½ years) =	$177,000
Depreciation adjusted to straight-line method	
(Years - actual useful life) 6 ½ x $465,000 =	100,750
(Years - estimated useful life) 30	
Depreciation in excess of straight-line depreciation	$76,250

Computation of Gain (or Loss)

Sales price - 12/31/73	$300,000
Historical cost - 7/1/67	$490,000
Depreciation adjusted to a straight-line method	100,750
Unrecovered cost	389,250
Gain (or loss) on sale	($ 89,250)

Computation of Net Depreciation Adjustment

Loss on sale	($ 89,250)
Depreciation in excess of straight-line depreciation	76,250
Net depreciation adjustment	($ 13,000)

EXAMPLE 4: Computation of Net Depreciation Adjustment After a Provider Becomes Subject to the Prospective Payment System for Hospital Inpatient Capital-Related Costs (Capital PPS)

Facts:

Historical costs - 12/31/87	$490,000
Estimated salvage value	$ 25,000
Amount to be depreciated	$465,000
Estimated useful life	30 years
Actual useful life	6 years
Sales price - 12/31/93	$300,000

Computation of net depreciation

Historical cost- 12/31/87	$ 490,000
Actual salvage value -Sales price -12/31/93	300,000
Recomputed basis for depreciation (Straight line method - $190,00 basis @ 6 years or $31,667 per year)	$ 190,000
Depreciation taken-(straight line method $465,000 basis @30 years or $15,500 per year for 6 years)	$ 93,000
Recomputed basis for depreciation	$190,000
Less depreciation taken	- 93,000
Net depreciation adjustment- additional depreciation allowed the provider	$ 97,000

Allocation of net depreciation adjustment to each reporting period before and after the effective date of capital PPS:

Fully prospective provider.

Fiscal Year Ending	Actual Depreciation Taken	Recomputed Depreciation	Loss On Sale	Net Depreciation Adjustment
12/31/88	$15,500	$31,667	$16,167	($16,167)
12/31/89	15,500	31,667	16,167	(16,167)
12/31/90	15,500	31,667	16,167	(16,167)
12/31/91	15,500	31,667	16,167	(16,167)
12/31/92	15,500	31,667	16,167	(16,167)
12/31/93	15,500	31,667	16,167	(16,167)

Adjustment to reimbursable cost before and after the effective date of capital PPS:

Facts Applicable to Example.

Fiscal Year Ending	Total Allowable Cost	HI Allowable Cost	Percent HI Cost
12/31/88	$640,000	$320,000	50%
12/31/89	630,000	252,000	40
12/31/90	600,000	120,000	20
12/31/91	580,000	104,000	18
12/31/92	570,000	85,000	15
12/31/93	550,000	55,000	10

Fiscal Year Ending	Total Allowable Cost	Part B Allowable Cost	Percent Part B Cost
12/31/92	$570,000	$39,900	7
12/31/93	550,000	33,000	6

Computation of adjustment to reimbursable cost.

Fiscal Year Ending	Percent HI Cost	Percent Part B Cost	Net Depreciation Adjustment	Adjustment To HI Reimbursable Costs
12/31/88	50%		($16,167)	($8,084)
12/31/89	40		(16,167)	(6,467)
12/31/90	20		(16,167)	(3,233)
12/31/91	18		(16,167)	(2,910)
12/31/92		7%	(16,167)	(1,132)
12/31/93		6	(16,167)	(970)
Total adjustment				($22,796)

132.3 Allocation of Net Depreciation Adjustments.--A provider will allocate its total net depreciation adjustments as determined in §§132.1 and 132.2 in accordance with the particular circumstances of either A, B, or C below. Where a provider does not have the depreciation or Medicare utilization information that is contained in the cost reports and is needed for the allocation or determination of adjustment to reimbursable cost for years prior to the 5-year limitation on retention of records, the provider will request such records from the intermediary. Where the intermediary does not have such records, the provider must use an average of Medicare utilization for the available years to be applied to the years that are not available.

A. Allocation Permitted in the Year of Disposal.--A provider shall reflect the net depreciation adjustment as an adjustment of depreciation in the year of disposal where either:

1. The HI utilization, based on cumulative total of Medicare covered days for all reporting periods in which depreciation on the asset disposed of was claimed under the Medicare program, is less than 5 percent of the cumulative total of inpatient days in the facility (certified area only) for the same reporting periods; or

2. The net depreciation adjustments applicable to all disposals of depreciable assets within the cost reporting period total $5,000 or less.

B. Allocation Where Provider Is Not Subject to Recovery of Accelerated Depreciation.--Where a provider is not subject to recovery of accelerated depreciation in accordance with the provisions of §136; when the conditions of paragraph A of this section are not met; and when in the case of demolished or abandoned assets, the assets are at least 80 percent depreciated, the provider will allocate the net depreciation adjustment to each reporting period based on the ratio of the total depreciation allowed on the disposed assets in each reporting period to the total depreciation applicable to such assets for all reporting periods under the program. The facts applicable to example 1 of §132.1 are used in the example below to demonstrate how the net depreciation adjustment is allocated to each reporting period under the program by multiplying the $41,000 by the ratio of depreciation determined for each period.

Allocation of Net Depreciation Adjustment to Each Reporting Period Under the Program.

Cost Report Period Ending	Disposed Asset Depreciation Per Cost Report	Percent Reporting Period Depreciation to Total Depreciation	Allocation of Net Depreciation Adjustment
6/30/69	$ 20,000	22	$ 9,020
6/30/70	19,000	21	8,610
6/30/71	18,000	20	8,200
6/30/72	17,000	19	7,790
6/30/73	16,000	18	7,380
Total	$ 90,000	100	$ 41,000

C. Allocation Where Provider Terminates and Is Subject to Recovery of Accelerated Depreciation.--Where a provider terminates participation in the program after July 1970; disposes of its depreciable assets and does not meet the conditions of paragraph A; and where in the case of demolished or abandoned assets, the assets are at least 80 percent depreciated, the net depreciation adjustment will be allocated to each reporting period under the program as follows:

1. The portion of the recomputed depreciation (straight-line method) that is applicable to reporting periods under the program is distributed proportionately to such periods.

2. The recomputed depreciation amount for each reporting period is compared to the actual taken in each period. The difference is the excess depreciation to be recovered.

3. The gain or loss is allocated proportionately to each reporting period under the program and is combined with the excess depreciation for that period to determine the net depreciation adjustment.

The following facts (taken from example 3, §132.1) will demonstrate how the net depreciation adjustment is allocated to each reporting period under the program.

Step 1- Recomputed depreciation $157,500 less depreciation taken before entrance into the program $105,000 equals $52,500 which is divided by the five equal periods to arrive at $10,500 for each period.

Step 2- In the schedule below, recomputed depreciation (column 3) is compared with actual depreciation taken (column 2) to arrive at excess depreciation (column 4).

Step 3- Excess depreciation (column 4) is combined with gain or loss (column 5) to arrive at net depreciation adjustment (column 6).

Allocation of Net Depreciation Adjustment to Each Reporting Period Under the Program.--

(1) Fiscal Year Ending	(2) Actual Depreciation Taken	(3) Recomputed Depreciation	(4) Excess Depreciation (2) - (3)	(5) Gain on Sale	(6) Net Depreciation Adjustment (4) + (5)
6/30/69	$ 20,000	$ 10,500	$ 9,500	$ 700	$ 10,200
6/30/70	19,000	10,500	8,500	700	9,200
6/30/71	18,000	10,500	7,500	700	8,200
6/30/72	17,000	10,500	6,500	700	7,200
6/30/73	16,000	10,500	5,500	700	6,200
Total	$ 90,000	$ 52,500	$ 37,500	$ 3,500	$ 41,000

D. Allocation Where the Provider is Subject to Capital PPS for Some Reporting Periods Under the Program.--After a hospital becomes subject to the capital PPS, the allocation of the net depreciation adjustment to each reporting period before and after the effective date of capital PPS must be in accordance with §2807.8.

132.4 Methods Available for Determination of Adjustment to Reimbursable Cost.--

A. Paragraph A of §132.3 describes the conditions under which a provider reflects the total net depreciation adjustment as an adjustment of depreciation in the year of disposal. Where these conditions are not met, a provider must first allocate the net depreciation adjustment to periods under the program in accordance with the provisions of paragraph B or C of §132.3. After the net depreciation for each reporting period under the program is determined:

1. The provider will compute the adjustment to reimbursable cost based upon the ratio of the program's share of reimbursable cost to total cost (see paragraph B).

2. On request of the provider, the intermediary may grant permission for the provider to compute the adjustment to reimbursable cost under the method described in paragraph C, if the provider can show that the direct costs of ancillary services furnished under arrangements in any cost reporting period, subject to recovery, are 10 percent or more of the direct costs of all ancillary services furnished.

3. Any provider may at its option compute the adjustment to reimbursable cost by recalculating, for each reporting period, all the necessary cost reporting schedules applicable to each reporting period covered by the depreciation adjustments. Schedules recomputed in accordance with this option must be submitted with the cost report for the cost reporting period in which the gain(s) or loss(es) giving rise to the depreciation adjustments took place.

The same method of computation must be used for all periods affected by the net depreciation adjustments that occur in the current reporting period.

B. Adjustment to Reimbursable Cost Based Upon the Ratio of the Program's Share of Reimbursable Cost to Total Cost.--The adjustment to reimbursable cost is computed by applying the ratio of Medicare reimbursable cost to total allowable cost for each period to the allowable portion of the net depreciation adjustment for that period. The Medicare reimbursable cost and total allowable cost includes inpatient services, nursing salary differential, outpatient and other Part B services, services provided by interns and residents not under an approved training program and ancillary services - Part B. Also, these amounts are gross allowable costs before deductibles and coinsurance billed to HI beneficiaries, return on equity capital, and the charge differential between semiprivate accommodations and less than semiprivate accommodations.

For each period under the program, that portion of the net depreciation adjustment which is applicable to nonallowable cost centers is excluded from the computation. The nonallowable portion is determined by multiplying the net depreciation adjustment for the period by the ratio of depreciation of nonallowable departments to the total depreciation claimed by the provider. See example in C below. To determine the effect on the Part B Trust Fund, the total adjustment to HI reimbursable cost for each period is multiplied by the ratio of Part B reimbursable cost to total reimbursable cost for each of the same periods. The difference between the adjustment to Part B Trust Fund will be the adjustment to Part A Trust Fund. The two examples below include no nonallowable cost centers.

Facts Applicable to Both Examples Below

Cost Report Period Ending	Total Allowable Cost	HI Allowable Cost	Percent HI Cost to Total Allowable Costs
6/30/69	$640,000	$320,000	50
6/30/70	$630,000	$252,000	40
6/30/71	$600,000	$120,000	20
6/30/72	$580,000	$104,000	18
6/30/73	$570,000	$ 85,500	15

Net Depreciation Adjustment Computed in §132.3B

Cost Report Period Ending	Percent HI Allowable Cost to Total Allowable Cost	Net Depreciation Adjustment	Adjustment to HI Reimbursable Cost
6/30/69	50	$ 9,020	$ 4,510
6/30/70	40	$ 8,610	$ 3,444
6/30/71	20	$ 8,200	$ 1,640
6/30/72	18	$ 7,790	$ 1,402
6/30/73	15	$ 7,380	$ 1,107
		$ 41,000	$ 12,103*

Net Depreciation Adjustments Computed in §l32.3C

Cost Report Period Ending	Percent HI Allowable Cost to Total Allowable Cost	Net Depreciation Adjustment	Adjustment to HI Reimbursable Cost
6/30/69	50	$ 10,200	$ 5,100
6/30/70	40	$ 9,200	$ 3,680
6/30/71	20	$ 8,200	$ 1,640
6/30/72	18	$ 7,200	$ 1,296
6/30/73	15	$ 6,200	$ 930
		$ 41,000	$ 12,646*

* This net adjustment is applied as a decrease to the extent of the HI reimbursable cost in the current cost reporting period and any excess not applied is treated as an overpayment to be recovered from the provider.

NOTE: Proprietary providers subject to recapture of accelerated depreciation can determine the effect that the net depreciation adjustment has on the computation of equity capital in accordance with the instructions contained under §§136.10ff. There is no similar prior year adjustment to equity capital for gains and losses on disposal of assets.

C. Apportionment of Net Depreciation Adjustment Based on Routine and Ancillary Utilization.--If the provider can demonstrate to the satisfaction of the intermediary that the method of recovery in B above would be inequitable, and can show that the direct costs of ancillary services furnished under arrangement are 10 percent or more of the direct costs of all ancillary services in any cost reporting period subject to the net depreciation adjustment, the intermediary may grant permission for the provider to compute the recovery under the following method.

Step l - The net depreciation adjustment for each period is first allocated to outpatient services, ancillary services (by ancillary departments where the Departmental Method was used), and nonallowable cost centers, on the basis of the ratio of depreciation (direct expense to the department) claimed for each of these cost centers to the total depreciation claimed by the provider. The residual net depreciation adjustment not allocated to these centers is then allocated to each routine service cost center on the basis of the ratio of depreciation claimed for each routine cost center to total depreciation claimed for all routine cost centers.

Step 2 - The adjustment to HI reimbursable cost for the net depreciation adjustment allocated to each cost center is determined based on the ratio of HI utilization to total utilization in the cost center, and utilizing the same basis for apportionment used in the provider's cost report, i.e., days and/or charges.

Schedule A demonstrates the process used to determine the adjustment to HI reimbursable cost based on a net depreciation adjustment in the amount of $25,920 for the period ending 12/31/67.

SCHEDULE A	(1)	(2)	(3)	(4)	(5)
Period ending 12/31/67	Depr. per Cost Rpt	% of Cost Ctr Depr. to Tot Depr	Allocation of Net Depr. Adjustment .(Col. 2 X line 1)	Percent HI Program Charges to Total Charges (Per Cost Report Settlement Sheet)	HI Adj. (4 X 3)
1. Net Depr. Adj.			$25,920		
2. Total Depr. per Cost Report	$74,139				
3. Depart. Method Ancillaries Cost-Drugs Sold Physical Therapy					
4. Comb. Method Total Ancillaries	$ 1,335	1.8%	$ 467	42.3%	$ 198
5. Nonallow. Cost Centers Beauty Shop	297	0.4%	104	0	
6. Net Depr. Adj. Subtotal			$ 571		
Routine Services		% of Routine Cost Center Depr. to Tot. Routine Depr.	Allocation of Routine Services (Col 2 x line 10 below)	% HI Utiliz. of Rout. Ser. (Per CR)	
7. Noncert. Routine Cost Center	$23,283	39.7%	$10,064	0	
8. Certified Routine Cost Center	35,365	60.3%	15,285	24.7%	3,775
9. Tot. Routine Depr. Cert. & Uncert.	$58,648	100.0%			
10. Net Depr. Adj. App. to Routine (line 1 - line 6)			$25,349		
11. HI Adjustment					$3,973
12. Allowance (See §132.3c)					79
13. Net Adjustment To HI Reimbursable Cost					$4,052