PROVIDER REIMBURSEMENT REVIEW BOARD
HEARING DECISION

98-D52

PROVIDER -Hermann Hospital
Houston, Texas

DATE OF HEARING-
October 16, 1996

Provider No. 45-0068

Cost Reporting Period Ended -
September 30, 1989

vs.

INTERMEDIARY -
Blue Cross and Blue Shield Association/
Blue Cross and Blue Shield of Texas

CASE NO. 92-1562

INDEX

ISSUES:

1. Was the Intermediary's adjustment of depreciation on equipment placed at the Provider by the University of Texas Health Science Center at Houston proper?

2. Was the Intermediary's disallowance of the Provider's claimed loss on disposal of certain depreciable assets proper?

STATEMENT OF THE CASE AND PROCEDURAL HISTORY:

Hermann Hospital ("Provider") is a 640-bed, general, acute care hospital located in Houston, Texas. The Provider operates a large graduate medical education program through its affiliation with the medical school of the University of Texas ("Medical School") which is part of the University of Texas Health Science Center at Houston ("UTHSCH"), which is a component of the University of Texas system ("University"). On its fiscal year ended ("FYE") September 30, 1989 cost report, the Provider claimed the costs in dispute in this case as allowable costs. Blue Cross and Blue Shield of Texas ("Intermediary") issued a Notice of Program Reimbursement ("NPR") to the Provider disallowing the disputed costs. The Provider filed a timely appeal with the Provider Reimbursement Review Board ("Board") pursuant to 42 C.F.R. §§ 405.1835-.1841 and has met the jurisdictional requirements of those regulations. The Medicare reimbursement effect is approximately $328,000.

Issue 1 - Depreciation of Equipment:

Facts:

The Provider serves as the main teaching facility in Houston for the Medical School. The Provider makes its clinical and other physical facilities available to the University, while the University provides clinical patient care, teaching, and research functions of the Provider. Since the outset of the affiliation, UTHSCH has purchased equipment to be placed at the Provider facility for use in providing patient care and in clinical research. Equipment included computers, EKG machines, MRI machines and other imaging devices, surgical instruments, intensive care monitoring devices, laboratory equipment, patient beds and office equipment ("Equipment").[1] Use of the Equipment is not limited to faculty and students of the University but is available to all providing clinical care to patients.[2]

UTHSCH maintains a capital inventory listing for the Equipment.[3] The Provider claimed

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[1] Transcript ("Tr.") at 168 and Provider Exhibits 6 and 7.

[2] Tr. at 193.

[3] See Provider Exhibit 6.

depreciation on the Equipment for FYE 1989. Such depreciation had previously been allowed in FYE 1987 as "donated assets" pursuant to 42 C.F.R. § 413.134(b)(8).[4] In FYE 1989, the Intermediary disallowed the expense because the parties were not related. The Intermediary made an interim proposal to allow depreciation as depreciation on donated assets but ultimately disallowed the expense citing the Provider's lack of documentation of ownership of the assets.

PROVIDER'S CONTENTIONS:

The Provider asserts that depreciation expense relating to the Equipment should be considered an allowable cost on its FYE 1989 cost report. The Provider and the University are "related parties," as defined by Medicare program regulations, and depreciation expense relating to the Equipment may be included in the Provider's cost report as an expense attributable to a related organization. 42 C.F.R. § 413.17(a). In the alternative, the Provider argues that it is entitled to claim depreciation expense relating to the Equipment as depreciation on assets purchased with public funds. Pursuant to 42 C.F.R. § 413.149, a provider may claim depreciation expense for such assets if they are used to provide services to Medicare beneficiaries. The Equipment placed at the Provider by UTHSCH was purchased with funds appropriated by the Texas legislature.[5] These funds constitute public funds under 42 C.F.R. § 413.149(b). As the Equipment was utilized to provide care to the Provider's patients including Medicare beneficiaries, the Provider is entitled to claim depreciation under 42 C.F.R. § 413.149. The Provider contends that failure to allow depreciation for these costs will result in impermissible shifting of costs from Medicare beneficiaries to non-Medicare patients. See 42 U.S.C. § 1395x(v)(1)(A)(I).

The Provider asserts that it is related to the University through affiliation and through common control. Under 42 C.F.R. § 413.17(b)(1), "related to the provider means that the provider to a significant extent is associated and affiliated with or has control of or is controlled by the organization furnishing the services, facilities, or supplies." The definition of "control" is set forth in 42 C.F.R. § 413.17(b)(3) as follows; "[c]ontrol exists where an individual or organization has the power, directly or indirectly, significantly to influence or direct the actions or policies of an organization or institution." HCFA Pub. 15-1 § 1004.3, clarifies that control is "any kind of control, whether or not it is legally enforceable and however it is exercisable or exercised. It is a reality of the control which is decisive, not its form or the mode of its exercise." The Provider notes that prior decisions have held that the power need only exist and it need not be exerted.[6]

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4 Tr. at 196.

5 Tr. at 164 and Provider Exhibits 42-45.

6 See Provider Post Hearing Brief at 12, n. 5.

The Provider cites numerous provisions of the Affiliation Agreement between it and University to show that control, including the dual appointment of staff and the physical connection of their buildings.[7] The Provider states that the Intermediary's argument that no related party relationship exists because neither party "dominated", is not a requirement under the regulations or manual provisions.[8] The Provider points to an example of administrative control in the manual at HCFA Pub. 15-1 § 1004.4; there a medical director of a provider also serves as the president and owner of a supplier entity. The Provider presented evidence that there were numerous joint appointments where the individuals held positions with authority to influence and control the affairs of both institutions.

The Provider also maintains that the Affiliation Agreement between the parties, and ensuing control and influence exercise between the parties creates a contractual relationship that has been held to invoke the related party principle. See HCFA Pub. 15-1 § 1004.4, Example 2 and Red Bank Community Hospital v. Blue Cross and Blue Shield Association/Blue Cross and Blue Shield of Tennessee, HCFA Administrator , November 15, 1983, Medicare and Medicaid Guide (CCH) ¶ 33,689. The evidence presented indicates that the Provider and the University are related and the Provider should be allowed to depreciate the Equipment it was supplied by its related party.

The Provider presented testimony that the Equipment was placed at the Provider for patient care and for its entire useful life.[9] The record also contains evidence that the Provider was responsible for maintaining the Equipment.[10]

The Provider also asserts that it can claim depreciation because the Equipment was purchased with public funds. The regulations at 42 C.F.R. § 413.149 provide for depreciation of assets financed with public funds. The Provider presented evidence that the Equipment was purchased at the request of the Joint Institutional Planning Committee composed of representatives of the Provider and University and was funded by the Texas Legislature.[11]

The Provider disagrees with the Intermediary's argument that it must own the assets to claim

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7 See Provider Exhibit 5, specifically Section II(F)(4)(b) for dual appointments and Tr. at 182 for physical connection of building.

8 Tr. at 30.

9 Tr. at 170 and 193-94.

10 Tr. at 170 and Provider Exhibit 41.

11 See Provider Exhibits 13, 42, and 45.

depreciation.[12] The regulation at 42 C.F.R. § 413.149 does not reference ownership but does reference assets financed with "public" funds. Also, in Hospital de Aurea de Carolina v. Cooperativa de Seguros, PRRB Dec. No. 89-26, March 13, 1989, conditionally aff'd HCFA Administrator , May 17, 1991, Medicare and Medicaid Guide (CCH) ¶ 39,232, assets that were not owned by the provider, but were owned by a public agency, were allowed to be depreciated by the provider.

INTERMEDIARY'S CONTENTIONS:

The Intermediary notes that this disallowance has been made in prior years. The Intermediary also claims that it previously, advised the Provider that it must prove ownership of the Equipment by transfer or donation, or that the University is a related party. The Provider claims that the assets were used to provide patient care and thus the source of the funds is not at issue. See 42 C.F.R. § 413.149. The Intermediary asserts that this regulation was to address the use of Hill-Burton and other public funds to purchase assets. The regulation does not address ownership of the assets, which is the true test at hand. The Intermediary maintains that the Provider does not hold legal title to the assets, and is not a related party to the University, therefore, the depreciation expense is not incurred by the Provider and not allowable.

Issue 2 - Loss on Disposal:

Facts:

The Provider's campus is composed of a number of interconnected buildings that have been added over the years to accommodate growth. The original building, the "Cullen Pavilion," has a distinctive masonry architectural design and serves as the nerve center for the campus. The issue concerns the recent renovation of the Cullen Pavilion. The building underwent renovations for life and safety code violations and removal of an asbestos hazard. Because of the extensiveness of the renovations, which removed all improvements and additions since 1925, the Provider treated the renovation as a retirement of those assets. The Provider had established a 40 year life on all assets regardless of age at the time it entered the Medicare program in 1966. Using its 1986 fixed asset ledger, the Provider identified assets that would not remain in service after the renovation.[13] The Provider also added to those losses, those assets relating to interim life-safety renovations carried out in FYE September 30, 1987 that would be removed during the renovation.[14] The net book value of the assets removed were approximately $3.2 million, based on the Provider's claimed loss. The Provider took one

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12 Intermediary Position Paper at 7.

13 Tr. at 66.

14 Tr. at 77.

third of the loss, $1,079,120.66, as a scrapping loss on its FYEs 1987, 1988 and 1989 cost reports. The renovation took place from June 1988 through June 1990.[15] During the renovation, most of the building interior was disposed of except for the exterior walls and structural supports.[16] The few interior items retained were part of the historical value of the original structure.[17]

In FYE 1987, the Intermediary disallowed the claimed loss of assets. The Intermediary indicated that the Provider was attempting to "relife" the assets.[18] The Intermediary also claimed that the Provider did not have adequate documentation of scrapping, and that the assets should be depreciated over their remaining useful life.[19]

The Intermediary indicated at the hearing that the Provider's accounting treatment of the assets that were removed during renovations amounted to a disposition of asset rather than relifing.[20] The Intermediary indicated that there had been both scrapping and demolition and that there were different Medicare treatments of those assets, and since the Provider was unable to identify the method for each item the Intermediary adjustment was appropriate.[21]

The Board considered this issue for FYE 1987 and affirmed the Intermediary's adjustment, citing the lack of evidence in the record that identified any assets that actually were disposed of in FYE 1987 as part of the renovation. See Herman Hospital v. Blue Cross and Blue Shield Association/ Blue Cross and Blue Shield of Texas, PRRB Case No. 95-D30, March 8, 1995, Medicare and Medicaid Guide (CCH) ¶ 43,240, at 44,277, declined rev. HCFA Administrator April 4, 1995 ("Hermann I"). The Board also found that the appeal record confirmed that both a scrapping and a demolition had occurred, and that to take the loss on disposal the Provider had to identify the manner of disposal and categories and values of the various building components. Id., at 44,279. The Provider did not seek review of the Board's

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15 Tr. at 45 and Provider Exhibit 37.

16 Tr. at 130.

17 Tr. at 47.

18 Tr. at 65 and 156.

19 See Intermediary Supplemental Position Paper at 3 and Tr. at 87-88.

20 Tr. at 157.

21 Id.

decision but has renewed its claim of a scrapping loss in FYE 1989.[22] The Intermediary denied the Provider's FYE 1989 claim on the same basis as the FYE 1987 adjustment.

PROVIDER'S CONTENTIONS:

The Provider asserts that it has met all of the criteria for a scrapping loss under the Medicare program. The Provider did not appeal Hermann I but has addressed the concerns raise by that Board in the present case by requesting Valuation Counselors ("VC") to conduct a detailed study of the project. VC produced an exhaustive list of the types and values of materials removed during renovation from June 1988 to June 1990. The Provider claims that the Intermediary admitted at the hearing that the Provider's original fixed asset record was sufficient documentation of the Provider's loss on disposal, if the Board deemed that all the assets were disposed of by scrapping.[23] The Provider disagrees with the decision in Hermann I that any assets were disposed of by demolition rather than by scrapping.

The treatment of gain or loss to be afforded assets that are disposed of depends on the manner of disposal, not the asset type. 42 C.F.R. § 413.134(f)(1). Under the regulation, scrapping is defined as "the physical removal from the provider's premises of tangible personal property which are no longer useful for its intended purposes and are only salable for its scrap or junk value." 42 C.F.R. § 413.134(d)(f)(2). The manual further clarifies that items that are usually considered demolished can be scrapped. It states that:

> [s]tructures 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.

HCFA Pub. 15-1 § 132 (emphasis added).

The four criteria to claim loss as a scrapping are: the asset must be "tangible personal property;" the asset must be capable of being detached: the asset must no longer be useful for its intended purpose; and, the asset must be salable only for scrap or junk value. The Provider indicates that its fixed ledger assets are building improvements which constituted tangible personal property. Some of these assets, such as doors, fixtures and elevators, are identical to examples given in HCFA Pub. 15-1 § 132. There was no doubt that they were removed

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[22] The FYE 1989 audit was completed prior to the FYE 1988 audit and thus is before the Board before the FYE 1988 appeal.

[23] Tr. at 153.

during the renovation.[24] The life safety violations that threatened loss of accreditation clearly satisfied the requirement that they no longer meet their intended purpose.[25] The Provider points out that the assets consisted of old door ceiling tiles, plumbing fixtures, HVAC system, elevators and other building assets of minimal intrinsic value, and therefore, could only be sold for their scrap or junk value. The contract with the project contractor addressed the value to be obtained.[26] HCFA Pub. 15-1 § 132 does not require the assets actually be sold in order to claim the scrapping loss.

The Intermediary's assertion that the assets were "demolished" is based upon the use of that word in the building contractor's weekly reports and certain blueprints.[27] The Intermediary also relies on the testimony of the project engineer at the Hermann I hearing, where it was noted that certain assets were broken in pieces before their removal.[28] The Provider notes that HCFA Pub. 15-1
§ 104.22 provides a definition for demolition as "[t]he deliberate destruction of a building or other asset resulting in the complete loss of economic value (other than the scrap value) of the asset." The difference between treatment of demolition and scrapping is explained in the preamble to the regulation establishing the distinction. 41 Fed. Reg. 35197 (August 20, 1976). It states:

> [w]hen a provider intentionally destroys or abandons a productive and valuable asset, it would be inequitable for the Medicare program to immediately reimburse the provider for the unused value if such asset could have been utilized in the provision of patient care.

Id. at 35198.

The assets are not a demolition because they were largely obsolete and outdated assets that did not meet life safety codes, and their disposal did not constitute a premature disposal of "productive and valuable" assets. Rather, they were "no longer useful for their intended purpose," consistent with the Medicare requirement for scrapping. The Provider indicates that the Intermediary should not rely on the use of the word "demolition" by others unfamiliar with its meaning under Medicare, and that one needs to look at the remaining useful life of the asset.

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24 Tr. at 130.

25 Tr. at 41-42 and Provider Exhibit 31.

26 Tr. at 63.

27 Tr. at 131 and Provider Exhibit 47.

28 See Intermediary Exhibit 6, Hermann I Tr. at 131.

The Provider assert that it has provided adequate documentation of the historical cost of the assets, the date assets were put in use, and their net book value.[29] The Provider also identified that the renovation took place in the June 1988 to June 1990 time period. In addition, the Provider submitted the VC study,[30] which identified the specific assets removed and estimated their value. The Provider noted that the total loss amounted to an amount less than that claimed ($2,970,617 versus $3,237,362) and assigned it across FYE 1988 through 1990.[31] The variance was attributed to the depreciation that should have been claimed in FYE 1987 but was not because of the loss claimed for that year. This documentation is in great enough detail to permit the loss to be taken according to VC's calculations for FYE 1988.

INTERMEDIARY'S CONTENTIONS:

The Intermediary indicates that the instant case mirrors Hermann I. Although the Provider has submitted additional documentation, it has not clearly indicated how assets were disposed of during the renovation. There must either be a demolition or a scrapping, or both. In Hermann I certain assets were demolished and others were scrapped. In FYE 1989, the Provider presents the VC study which claims that virtually all of the assets were scrapped. The Intermediary claims that the VC study fails to identify which assets were scrapped and which were demolished. This is critical since the reimbursement treatment differs for a demolition versus a scrapping. In accordance with 42 C.F.R. §§ 413.24 and 413.20, the Provider must document the nature of the disposal of these assets.

Furthermore, the Intermediary argues that the Provider's documentation is insufficient to trace specific assets to the Provider's depreciation schedule. The Provider's accounting records identify the building additions without delineation between additions to the shell, interior fixtures, or building systems. Therefore, the disposed assets net book values for calculating loss cannot be determined. The Intermediary also maintains that the time of the disposal is necessary in computing the loss.

The Intermediary concludes that proper documentation does not exist to determine the Provider's actual Medicare loss on disposal of assets from the renovation. The Provider failed to identify which assets were scrapped versus demolished, and when that took place. The Provider's financial records do not have the details necessary to determine the net book values for computing their loss. Therefore, pursuant to 42 C.F.R. §§ 413.24 and 413.20, the Provider has not met its documentation burden for supporting its claimed loss on disposal, and is not entitled to a loss on disposal of fixed assets.

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29 See Provider Exhibit 23.

30 See Provider Exhibit 30.

31 See Provider Exhibits 30 and 46.

The Provider was represented by J.D. Epstein, Esquire, and Nancy Legros, Esquire, of Vinson and Elkins. The Intermediary was represented by Bernard M. Talbert, Esquire, of the Blue Cross and Blue Shield Association.

CITATIONS OF LAWS, REGULATIONS AND PROGRAM INSTRUCTIONS:

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

§ 1395x(v)(1)(A)(I)	-	Reasonable Cost

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

§ 413.9	-	Cost Related to Patient Care
§ 413.17	-	Cost Related to Patient Care
§ 413.20	-	Financial Data and Reports
§ 413.24	-	Adequate Cost Data and Cost Finding
§ 413.134 et seq.	-	Depreciation: Allowance for Depreciation Based on Asset Costs
§ 413.149	-	Depreciation: Allowance for Depreciation on Assets Financed with Federal or Public Funds

3. Program Instructions - Provider Reimbursement Manual, Part I (HCFA Pub. 15-1):

§ 104.22	-	Demolition
§ 132 et seq.	-	Gains and Losses on Disposal of Depreciable Assets (Excluding Involuntary Conversions)
§ 1000 et seq.	-	Costs to Related Organizations

4. Cases:

Herman Hospital v. Blue Cross and Blue Shield Association/Blue Cross and Blue Shield of Texas, PRRB Case No. 95-D30, March 8, 1995, Medicare and Medicaid Guide (CCH) ¶ 43,240, declined rev. HCFA Administrator April 4, 1995.

Hospital de Aurea de Carolina v. Cooperativa de Seguros, PRRB Dec. No. 89-26, March 13, 1989, conditionally aff'd HCFA Administrator, May 17, 1991, Medicare and Medicaid Guide (CCH) ¶ 39,232.

Red Bank Community Hospital v. Blue Cross and Blue Shield Association/Blue Cross and Blue Shield of Tennessee, HCFA Administrator, November 15, 1983, Medicare and Medicaid Guide (CCH) ¶ 33,689.

5. Other:

41 Fed. Reg. 35197 (August 20, 1976).

FINDINGS OF FACT, CONCLUSIONS OF LAW AND DISCUSSION:

The Board, after consideration of the facts, parties' contentions, evidence presented, testimony elicited at the hearing, and post hearing brief, finds and concludes as follows:

Issue 1- Depreciation of Equipment:

The Board finds that the parties are related, and, thus, the Provider need not claim ownership to claim depreciation costs for the Equipment. The record also shows that the Equipment was clearly used for patient care and was maintained by the Provider.

The Board finds that the University is related to the Provider through affiliation and through common control. Under 42 C.F.R. § 413.17(b)(1), "related to the provider means that the provider to a significant extent is associated and affiliated with or has control of or is controlled by the organization furnishing the services, facilities, or supplies." The definition of "control" is set forth in 42 C.F.R. § 413.17(b)(3) as follows: "[c]ontrol exists where an individual or organization has the power, directly or indirectly, significantly to influence or direct the actions or policies of an organization or institution. In HCFA Pub. 15-1 § 1004.3, control is clarified to mean, "any kind of control, whether or not it is legally enforceable and however it is exercisable or exercised. It is a reality of the control which is decisive, not its form or the mode of its exercise."

The Board notes that numerous provisions of the Affiliation Agreement creates power in each

party over the actions of the other.[32] The parties agree, in Section II.A.3, to appoint certain University personnel as Clinical Chiefs at the Provider. The Affiliation Agreement, at Section E, establishes joint responsibility for Biomedical Research. The Affiliation Agreement, in Section G.1, establishes a Joint Conference Committee with members of both institutions whose responsibility is to make joint recommendations. The Affiliation Agreement creates a Joint Institutional Planning Committee, in Section G.2 , which exercises control over joint programs. And, under the provisions of Section G.4(a) and (b) of the Affiliation Agreement, the Medical Board composition includes members of both institutions and the Medical Director is appointed with the concurrence of the University. The Board finds that the ability of one party to influence and control the action of the other demonstrates related party status under 42 C.F.R. § 413.17, and the manual provisions at HCFA Pub. 15-1 § 1000 et seq.

In addition, the Board finds that the Provider presented testimony that the Equipment was placed at the Provider for patient care for its entire useful life.[33] The record also contains evidence that the Provider was responsible for maintaining the Equipment.[34]

Since the evidence indicates that the Provider and the University are related, the Provider should be allowed to depreciate the Equipment supplied by its related party and used for patient care.

Issue 2 - Loss on Disposal:

The Board finds that the Provider has not provided sufficient documentation to clearly indicate how assets were disposed of during the renovation in order to support its claim for loss on disposal.

The Board notes that in Hermann I evidence was found that both scrapping and demolition had occurred. See Hermann I at CCH ¶ 43,240, at 44,279. Since the reimbursement treatment differs for a demolition versus a scrapping, 42 C.F.R. § 413.134(f), the Provider was denied relief because it could not document the nature of the disposal of these assets. 42 C.F.R. §§ 413.24 and 413.20.

In the instant case, the Provider asserts that, except for materials that were removed and reused or removed and stored, all of the assets were scrapped.[35] The Board did not find detailed new evidence concerning which items were either scrapped or demolished.

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32 See Provider Exhibit 5.

33 Tr. at 170 and 193-94.

34 Tr. at 170 and Provider Exhibit 41.

35 See Provider Exhibit 30 at 1.

Documentation that the contractor was supposed to scrap all materials was not presented.[36] The Board adheres to the decision in Hermann I finding that there was both a demolition and a scrapping. The additional documentation presented by the Provider provides more detailed information on the time frames of disposal of assets, but does not clearly indicate what items were demolished or scrapped.

The Board also agrees with the Intermediary's assertion that the Provider's documentation is insufficient to trace specific assets to the Provider's depreciation schedule. The Provider's accounting records identify the building additions without delineation between additions to the shell, interior fixtures, and building systems. Therefore, the disposed assets net book values for calculating loss cannot be determined. The Board notes that the level of detail that is usually maintained in accounting records would preclude most scrapping claims. In any event, the Provider does not have sufficiently detailed records that match the items in the renovations with the items scrapped. The Board finds that the Provider's financial records do not have the details necessary to determine the net book values for computing their loss. Therefore, pursuant to 42 C.F.R. §§ 413.24 and 413.20, the Provider has not met its documentation burden for supporting its claimed loss on disposal, and is not entitled to a loss on disposal of fixed assets.

DECISION AND ORDER:

Issue 1 - Depreciation of Equipment:

The Intermediary's adjustment reducing the Provider's claim for depreciation was improper. The Intermediary's adjustment is reversed.

Issue 2 - Loss on Disposal:

The Intermediary's adjustment disallowing the Provider's scrapping claim was proper. The Intermediary's adjustment is affirmed.

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[36] Tr. at 63.

Board Members Participating:

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

Date of Decision: May 21, 1998

FOR THE BOARD:

Irvin W. Kues
Chairman