

(ii) The net book value in the hands of the owner last participating in the Medicare program.

(3) *Transfers of State hospitals to non-profit corporations 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 purposes of this section, monetary consideration includes cash, new debt, and assumed debt.

(k) *Transactions involving a provider's capital stock*—(1) *Acquisition of capital stock of a provider.* If the capital stock of a provider is acquired, the provider's assets may not be revalued. For example, if Corporation A purchases the capital stock of Corporation B, the provider, Corporation B continues to be the provider after the purchase and Corporation A is merely the stockholder. Corporation B's assets may not be revalued.

(2) *Statutory merger.* A statutory merger is a combination of two or more corporations under the corporation laws of the State, with one of the corporations surviving. The surviving corporation acquires the assets and liabilities of the merged corporation(s) by operation of State law. The effect of a statutory merger upon Medicare reimbursement is as follows:

(i) *Statutory merger between unrelated parties.* If the statutory merger is between two or more corporations that are unrelated (as specified in § 413.17), the assets of the merged corporation(s) acquired by the surviving corporation may be revalued in accordance with paragraph (g) of this section. If the merged corporation was a provider before the merger, then it is subject to the provisions of paragraphs (d)(3) and (f) of this section concerning recovery of accelerated depreciation and the realization of gains and losses. The basis of the assets owned by the surviving corporation are unaffected by the transaction. An example of this type of transaction is one in which Corporation A, a nonprovider, and Corporation B, the provider, are combined by a statutory merger, with Corporation A being the surviving corporation. In

such a case the assets of Corporation B acquired by Corporation A may be revalued in accordance with paragraph (g) of this section.

(ii) *Statutory merger between related parties.* If the statutory merger is between two or more related corporations (as specified in § 413.17), no revaluation of assets is permitted for those assets acquired by the surviving corporation. An example of this type of transaction is one in which Corporation A purchase the capital stock of Corporation B, the provider. Immediately after the acquisition of the capital stock of Corporation B, there is a statutory merger of Corporation B and Corporation A, with Corporation A being the surviving corporation. Under these circumstances, at the time of the merger the transaction is one between related parties and is not a basis for revaluation of the provider's assets.

(3) *Consolidation.* A consolidation is the combination of two or more corporations resulting in the creation of a new corporate entity. If at least one of the original corporations is a provider, the effect of a consolidation upon Medicare reimbursement for the provider is as follows:

(i) *Consolidation between unrelated parties.* If the consolidation is between two or more corporations that are unrelated (as specified in § 413.17), the assets of the provider corporation(s) may be revalued in accordance with paragraph (g) of this section.

(ii) *Consolidation between related parties.* If the consolidation is between two or more related corporations (as specified in § 413.17), no revaluation of provider assets is permitted.

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§ 413.139 Depreciation: Optional allowance for depreciation based on a percentage of operating costs.

(a) *Principle.* With respect to 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 provider's 1965 operating costs or the provider's current year's allowable costs, whichever are the lower. The percentage 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 regular depreciation on assets acquired after 1965; however, if the optional allowance is selected, the combined amount of such allowance on pre-1966 assets and the straight-line depreciation on assets acquired after 1965 (including the estimated depreciation on assets held on a rental basis during the current year) may not exceed 6 percent of the provider's allowable cost for the current year.

(b) *Definitions*—(1) *Operating costs*. Operating costs are the total costs incurred by the provider in operating the institution or facility.

(2) *Allowable costs*. Allowable costs are the costs of a provider that are includable under the principles for cost reimbursement. Through application of apportionment methods to the total amount of such allowable costs, the share of a provider's total cost that is attributable to covered services for beneficiaries is determined.

(c) *Application*. If a provider has inadequate historical cost records for pre-1966 depreciable assets, the provider may elect to receive an allowance for depreciation on such assets based on a percentage of operating costs. The optional allowance for depreciation for such assets may be used, however, whether or not a provider has records of the cost of pre-1966 depreciable assets currently in use.

(d) *Allowance based on a percentage of operating costs*. (1) The allowance for depreciation based on a percentage of operating costs is to be computed by applying a specified percentage to a base amount equal to the provider's 1965 total operating costs, without adjustments to these principles or the current year's allowable operating costs, whichever is lower. The percentage to be applied is five for the reporting period that starts before or during 1966-67, four and one-half for the reporting period that begins during 1967-68, and continues to decline annually

by equal amounts to become zero in 1976-77.

(2) If used as a base for determining the optional allowance for depreciation, neither the 1965 operating costs nor the current year's allowable costs are to include any actual depreciation, estimated depreciation on rented depreciable-type assets, allowance in lieu of specific recognition of other costs, or return on equity capital. Such exclusions are to be made only for the purpose of computing the allowance for depreciation based on operating costs. For other purposes, the excluded amounts are recognized in determining allowable costs and for computing the costs of services furnished to Medicare beneficiaries during the reporting period.

(e) *Change to actual depreciation*. (1) A provider that elects this allowance may at any time before 1976 change to actual depreciation on all pre-1966 depreciable assets. In such case, this option is eliminated and the provider can no longer elect to receive an allowance for depreciation based on a percentage of operating costs.

(2) If the provider desires to change to actual depreciation but either has no historical cost records or has incomplete records, the determination of historical cost may be made through appropriate means involving expert consultation with the determination being subject to review and approval by the intermediary.

(f) *Determination of optional allowance based on percentage of operating costs illustrated*. The following illustrates how the provider would determine the optional allowance for depreciation based on operating costs.

Example No. 1. The provider keeps its records on a calendar year basis. The current year's actual allowable cost and the actual operating cost for 1965 do not include any actual depreciation or rentals on depreciable-type assets. The current year's allowable cost also does not include any allowance in lieu of specific recognition of other costs or return on equity capital.

YEAR 1966	
Current year's allowable cost	\$1,100,000
Operating cost for 1965 ¹	\$1,000,000
Percent for determining the allowance	5

YEAR 1966—Continued

Allowance	\$50,000
¹ 1965 Operating cost was used in computing the allowance for depreciation based on a percentage of operating costs because it was lower than 1966 allowable cost.	

YEAR 1967

Current year's allowable cost	\$1,200,000
Operating cost for 1965 ¹	\$1,000,000
Percent for determining the allowance ²	5
Allowance	\$50,000

¹ 1965 Operating cost was used in computing the allowance for depreciation based on a percentage of operating costs because it was lower than 1967 allowable cost.
² Since the reporting period began during the year 1966-1967 (July 1, 1966-June 30, 1967) 5 percent is the percentage to be used.

YEAR 1968

Operating cost for 1965	\$1,000,000
Current year's allowable cost ¹	\$900,000
Percent for determining the allowance ²	4½
Allowance	\$40,500

¹ The current year's allowable cost was used in computing the allowance for depreciation based on percentage of operating costs because it was lower than 1965 operating cost.
² Since the reporting period began during the year 1967-1968 (July 1, 1967-June 30, 1968) 4½ percent is the percentage to be used.

Example No. 2. When the provider pays rent for depreciable-type assets rented prior to 1966, the estimated depreciation on such assets must be deducted from the allowance. The following illustration demonstrates how the allowance is determined.

The provider keeps its records on a calendar year basis. The current year's actual allowable cost and the actual operating cost for 1965 did not include any actual depreciation, allowance in lieu of specific recognition of other costs, or return on equity capital. However, such costs have been adjusted to exclude estimated depreciation on rented depreciable-type assets.

YEAR 1966

Adjusted current year's allowable cost	\$1,100,000
Adjusted operating cost for 1965 ¹	\$1,000,000
Percent for determining the allowance	5
Allowance	\$50,000
Less estimated depreciation for depreciable-type assets rented prior to 1966 on which rental is paid in 1966	\$3,000
Adjusted allowance	\$47,000

¹ 1965 operating cost was used in computing the allowance for depreciation based on a percentage of operating costs because it was lower than 1966 allowable cost.

(g) *Limitation on depreciation if optional allowance is used.* This optional allowance only is subject to a limitation based on the provider's total allowable operating cost for the current year. To determine this limitation, compute the sum of the actual depreciation

claimed, the allowance based on a percentage of operating costs, and the estimated straight-line depreciation on depreciable-type assets rented after 1965. If this sum exceeds six percent of the provider's current year's allowable cost (exclusive of any actual depreciation claimed, estimated depreciation on rented depreciable-type assets, allowance in lieu of specific recognition of other costs, and return on equity capital), the allowance for depreciation based on a percentage of operating costs is reduced by the amount of excess. In applying this limitation, if the actual depreciation claimed is on an accelerated basis, it must be converted to a straight-line basis only for use in calculating this limitation. It is presumed that pre-1966 assets will not be retired at a greater than normal rate, and the limitation of six percent, as it affects the availability of the allowance, is designed as a safeguard if the presumption is not borne out. If the provider does not elect to use the optional allowance, the combined allowance for depreciation based on costs of pre-1966 assets and those subsequently acquired is not subject to the six percent limitation.

Example No. 1. The following illustration demonstrates how this limitation would be determined.

YEAR 1966

[The provider keeps its records on a calendar year basis. The current year's actual allowable cost and the actual operating cost for 1965 have been adjusted to exclude actual depreciation, the estimated depreciation on rented depreciable-type assets, allowance in lieu of specific recognition of other costs, and return on equity capital.]

Adjusted operating cost for 1965	\$1,000,000
Percent for determining the allowance	5
In 1966 assets were acquired which produce a straight-line depreciation of	\$18,000
Estimated depreciation on assets rented in 1966	\$2,000
Adjusted allowable operating cost for 1966	\$1,100,000

CALCULATION OF ALLOWANCE FOR DEPRECIATION BASED ON A PERCENTAGE OF OPERATING COSTS

Gross allowance	
5 percent times adjusted 1965 operating costs (\$1,000,000)	\$50,000
Estimated depreciation on assets rented in 1966	2,000
Straight-line depreciation on post-1965 assets	18,000
Total	70,000
6 percent of adjusted 1966 allowable operating cost	66,000
Reduction in allowance	4,000
Allowance	50,000

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YEAR 1966—Continued

[The provider keeps its records on a calendar year basis. The current year's actual allowable cost and the actual operating cost for 1965 have been adjusted to exclude actual depreciation, the estimated depreciation on rented depreciable-type assets, allowance in lieu of specific recognition of other costs, and return on equity capital.]

Reduction	4,000
Adjusted allowance	46,000
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Total depreciation allowance for 1966 (\$18,000 actual depreciation plus \$46,000 allowance based on oper- ating cost)	64,000

Assume in this illustration that the provider had elected to use the declining balance method in computing its allowable depreciation and the rental expense for depreciable-type assets was \$3,500. In that case, it would include in its 1966 allowable cost not only the \$46,000 allowance based on operating costs but also \$36,000 (in this instance 2×straight-line rate is used) in actual depreciation and the rental expense of \$3,500—or a total of \$85,500 covering all its depreciable assets.

§ 413.144 Depreciation: Allowance for depreciation on fully depreciated or partially depreciated assets.

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

(b) *Application.* Depreciation is allowable on assets being used at the time the provider enters into the program. This applies even though such assets may be fully depreciated on the provider's books or fully depreciated with respect to other third-party payers. So long as an asset is being used, its useful life is considered not to have ended, and consequently the asset is subject to depreciation based upon a revised estimate of the asset's useful life as determined by the provider and approved by the intermediary. Correction of prior years' depreciation to reflect revision of estimated useful life should be made in the first year of participation in the program unless the provider has used the optional method (§ 413.139), in which case the correction should be made at the time of discontinuing the use of that method. If an asset has become fully depreciated under Medicare, further depreciation is not appropriate

or allowable, even though the asset may continue in use.

(c) *Example of an allowance for a fully-depreciated asset.* For example, if a 50-year-old building is in use at the time the provider enters into the program, depreciation is allowable on the building even though it has been fully depreciated on the provider's books. Assuming that a reasonable estimate of the asset's continued life is 20 years (70 years from the date of acquisition), the provider may claim depreciation over the next 20 years—if the asset is in use that long—or a total depreciation of as much as twenty-seventieths of the asset's historical cost.

(d) *Corrections to depreciation.* If the asset is disposed of before the expiration of its estimated useful life, the depreciation would be adjusted to the actual useful life. Likewise, a provider may not have fully depreciated other assets it is using and finds that it has incorrectly estimated the useful lives of those assets. In such cases, the provider may use the corrected useful lives in determining the amount of depreciation, provided such corrections have been approved by the intermediary.

§ 413.149 Depreciation: Allowance for depreciation on assets financed with Federal or public funds.

(a) *Principle.* Depreciation is allowed on assets financed with Hill-Burton or other Federal or public funds.

(b) *Application.* Like other assets (including other donated depreciable assets), assets financed with Hill-Burton or other Federal or public funds become a part of the provider institution's plant and equipment to be used in furnishing services. It is the function of payment of depreciation to provide funds that make it possible to maintain the assets and preserve the capital employed in the production of services. Therefore, irrespective of the source of financing of an asset, if it is used in the providing of services for beneficiaries of the program, payment for depreciation of the asset is, in fact, a cost of the production of those services. Moreover, recognition of this cost is necessary to maintain productive capacity for the future. An incentive for funding of depreciation is provided in