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Update for Tax-Exempt Health Care Entities: Accounting, Auditing & Tax

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Andrew Prather - Profile

Andrew Prather, CPA, is an audit shareholder at Clark Nuber P.S. serving a wide range of not-for-profit, private company, and governmental clients. Andrew serves as the firm's Quality Control Director overseeing the firm's internal inspection and peer review processes, as well as implementation of new professional standards. Andrew has served as the chair of the Washington Society of CPA's (WSCPA) Not-for-Profit Committee and the WSCPA Not-for-Profit Conference. He has been a frequent speaker at conferences, seminars, and webcasts. He is a member AICPA's Not-for-Profit Expert Panel and NPO Audit Guide Revision Task Force and has served as a writer and reviewer of the AICPA's Not-for-Profit Audit Risk Alert. Andrew serves on the Board of Directors of a local not-for-profit organization.

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Bob Heller - Profile

As shareholder in charge of the firm’s state and local tax practice, Bob has extensive experience in Washington State, multi-state and state tax controversy client matters. Bob provides services to clients in manufacturing, high-tech, life sciences, real estate, e-commerce, and other industries. Having served as the Senior Assistant Director for Tax Policy at the Washington Department of Revenue, Bob brings a unique perspective to tax consulting.

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A&A Update

New Accounting Standards

- Financial Accounting Standards Board (FASB)
  - Not-for-profit health care organizations (HCOs)
- Government Accounting Standards Board (GASB)
  - Governmental HCOs

Industry Consolidation Issues

- “New” NFP Business Combinations Standard
  - FASB ASC 958-805 NFP Business Combinations, effective in 2010
  - Merger or acquisition
  - Accounting “begins” at the merger/acquisition date

Industry Consolidation Issues

- Fair value measurements, particularly for acquisitions
  - Goodwill & other intangibles
  - Use of specialists

Industry Consolidation Issues

- Goodwill impairment testing
  - FASB ASC 350 requires testing for impairment at least annually; two-step test
  - ASU 2011-08, Testing Goodwill for Impairment
    - May begin their impairment valuation by assessing whether any events or circumstances occurred might indicate that a reporting unit’s fair value is less than its carrying amount;
    - Would not need to perform the quantitative two-step test unless assessment indicates likely impairment
    - Modifies the indicators that should be considered with respect to interim testing for impairment
    - Effective for years beginning after 12/15/2011, but early adoption is permitted

Patient Service Revenue, Provision for Bad Debts, and the Allowance for Doubtful Accounts

- ASU 2011-07 effective dates –
  - Public entities - fiscal years & interim periods beginning after 12/15/2011
  - Nonpublic entities – fiscal years ending after 12/15/2012
  - Early adoption is permitted

Patient Service Revenue, etc.

- Applies to:
  - Applies to HCOs that recognize patient service revenue at the time services are rendered even though the HCO does not assess the patient's ability to pay
  - Intended to apply to HCOs with significant amounts of uncompensated care (e.g., charity and self-pay write-offs)
  - Not intended to affect other HCOs

Patient Service Revenue, etc.

- Applicable HCOs required to:
  - Change the presentation of their statement of operations by reclassifying the provision for bad debts associated with patient service revenue from operating expense to deduction from patient service revenue, and
  - Provide enhanced disclosures about policies for recognizing revenue and assessing bad debts
- Bad debts associated with activities other than patient service revenue are not reclassified

AICPA Technical Q&A (TIS 6400.47)

- *Inquiry* – How to apply ASU 2011-07 in consolidated financials with:
  - parent holding company,
  - one subsidiary that ASU 2011-07 applies to,
  - one subsidiary that ASU 2011-07 does not apply to?

AICPA Technical Q&A (TIS 6400.47)

- *Response –*
  - ASU 2011-07 is silent on this issue
  - Subsidiary A and Subsidiary B would apply the accounting guidance for their stand-alone financials
  - For the consolidated financials, the presentation of bad debt is an accounting policy election. **Either retain the reporting of each individual subsidiary, or restate to report consistently.**
  - Disclose the accounting policy

Presentation of Insurance Claims and Related Insurance Recoveries

- ASU 2010-24 effective fiscal years beginning after 12/15/2010
- Diversity in practice related to accounting by HCOs for medical malpractice claims and similar liabilities and the related anticipated insurance recoveries --- report net or gross?

Presentation of Insurance Claims and Related Insurance Recoveries

- A HCO should not net insurance recoveries against a related claim liability
- Claim liability should be determined without consideration of insurance recoveries
- Also applies to contingent liabilities other than malpractice
- A cumulative-effect adjustment should be recognized in opening equity/net assets in the period of adoption if any difference as a result of application

Measuring Charity Care for Disclosure

- ASU 2010-23 effective fiscal years beginning after 12/15/2010, apply retrospectively
- Diversity in practice regarding the measurement basis used in the disclosure of charity care --- cost vs. revenue?

Measuring Charity Care for Disclosure

- Requires that cost be used as the measurement basis for charity care disclosure
- Cost is identified as the direct and indirect costs of providing charity care
- Disclose the method used to identify or determine costs and the amount of funds received to offset or subsidize charity services provided (e.g. gifts or grants)

Disclosure About Credit Quality of Financing Receivables

- ASU 2010-20 effective dates –
  - Public entities – periods ending on or after 12/15/2010 for disclosures as of the end of the reporting period; periods beginning on or after 12/15/2010 for disclosures about activity that occurs during a reporting period
  - Nonpublic entities – periods ending on or after 12/15/2011

Disclosure About Credit Quality of Financing Receivables

- Improve disclosures about credit risk exposure and the adequacy of the allowance against financing receivables
- Does not change recognition, valuation, or presentation of financing receivables

What is a Financing Receivable?

- Definition: recorded assets representing a contractual right to receive money either on demand or on fixed or determinable dates (e.g. loans, trade receivables, notes receivable, etc.)
- ASU 2010-20 specifically exempts the following from disclosure requirements – short-term trade receivables, receivables measured at FV or the lower of cost and FV, pledges receivable, leases receivable

Changes to Disclosures

- Required on a disaggregated basis
  - Portfolio segment: “The level at which an entity develops and documents a systematic methodology for determining its allowance for credit losses.”
  - Class: A further disaggregation of the portfolio segment.
- Examples
  - Portfolio segment: student loans, faculty or staff loans, wholesale customers, retail customers
  - Class: initial measurement method, risk characteristics

Amendments to Existing Disclosures

- A rollforward of the allowance for credit losses from beginning to end of reporting period
  - On a portfolio segment basis
  - With ending balance disaggregated by impairment method
- For each ending balance above, the related recorded investment in the FR
- The nonaccrual status of FRs *(past due receivables for which interest is no longer accrued),* by class
- Impaired FRs, by class

Additional Disclosures

- Credit quality indicators at the end of the reporting period, by class
  - Information on data used
  - Date range of information used
- Aging of past due FRs at the end of the reporting period, by class
- Nature and extent of troubled debt restructurings, by class
- Significant purchases and sales of FR, by portfolio segment

GASB 60 – Accounting for Service Concession Arrangements

- Example – transferor gov't engages a private sector entity or another gov't to operate a major capital asset (hospital, student housing, toll roads) in return for the right to collect fees from users of the capital asset
- Key – transferor maintains decision-making control over key aspects of the services provided

GASB 60 – Accounting for Service Concession Arrangements

- Guidance for transferors and operators
- Capital assets, up-front payments, obligations
- Effective – periods beginning after 12/15/2011

GASB 61 – Financial Reporting Entity (Amendment to GASB 14)

- Effective for periods beginning after 6/15/2012
- Amendments likely to impact HCOs:
  - Old (GASB 14) – include entity that is fiscally dependent
  - New (GASB 61) – must have fiscal dependency and a financial benefit or burden relationship

GASB 61 – Financial Reporting Entity (Amendment to GASB 14)

- Old – blending required in two situations
- New – modifies one, adds a third:
  - If have substantially the same governing body, must also (a) have financial benefit/burden, or (b) management has operational responsibility
  - Blending required when component unit's debt will be repaid entirely or almost entirely by the resources of the reporting HCO

GASB 61 – Financial Reporting Entity (Amendment to GASB 14)

- New – If all activity presented in single column, disclosed condensed combining information (including cash flows) of blended CUs
- New – Presentation of equity interests in discretely presented CUs
  - Asset on reporting HCO's balance sheet
  - Minority interest reported on CUs balance sheet as restricted nonexpendable net assets

GASB 62 – Codification of Pre-Nov. 1989 FASB/AICPA Pronouncements

- Finally!!!
- Effective periods beginning after 12/15/2011
- Eliminates the GASB 20 option to apply post-Nov. 1989 FASB standards
- Chapter 15 of the AICPA HCO Audit & Accounting Guide provides cross-reference table

AICPA'S Overhauled HCE Audit & Accounting Guide

- Issued Fall 2011
- New chapters on:
  - municpal bonds
  - derivatives
  - unique FS considerations for HCOs
- Companion document: annual Health Care Industry Developments Audit Risk Alert
- www.cpa2biz.com

New Auditing Standards

- AICPA's "Clarified" Auditing Standards
- Effective for audits of 12/2012 year-ends
- Complete re-write of the auditing standards to improve "clarity"
- New wording for auditors' report
- New requirements for "group audits"
- New requirements for auditing opening balances in initial audits
- Various "minor" changes

New Auditing Standards

- *2011 Government Auditing Standards*
- 2011 revision effective for audits of 12/2012 year-ends
- <u>Must document consideration of management's ability to effectively oversee nonaudit services & other issues related to independence</u>
- Routine assistance and consultation during audit not considered nonaudit service

On the Horizon - GASB

- Gov't Combinations
- Exposure draft issued March 2012
- Project Description: The primary objective of this project is to consider the financial reporting requirements for government combinations that are accomplished through mergers and acquisitions. This project includes the analysis of government combinations that have taken place in both the general governmental area (city/county consolidations and consolidated school districts, for example) and the business-type activities area (healthcare organizations, for example). In addition, the project addresses certain devolution (spin-off) issues; for example, accounting for a library district that was formerly a department in a primary government.

On the Horizon - FASB

- IFRS adoption by U.S. entities
- IFRS / US GAAP convergence projects
- Private companies GAAP
- Not-for-Profit Advisory Committee

<u>Adoption</u> of IFRS by U.S. Public Companies

- SEC action
  - November 2008 – Proposed roadmap for IFRS adoption
    - Decided to make a decision in 2011 regarding adoption beginning in 2014
  - March 2010 – Issued statement reaffirming support of <u>convergence</u> of U.S. GAAP and IFRS
    - Will make a decision in 2011 regarding adoption
    - Effective date moved back to 2015-2016 at earliest
  - December 2011 – staff need “a few more months” to produce final report; SEC commissioners not expected to make a decision before the staff work is completed

U.S. GAAP Convergence with IFRS

- Convergence vs. Adoption
- 2006 – FASB and IASB signed Memorandum of Understanding
  - Commitment to converging U.S. GAAP and IFRS
  - FASB projects since 2006 have primarily been focused on convergence with IFRS

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- 2012 – where are we now?

U.S. GAAP Convergence with IFRS

- 12/6/2011 speech by FASB Chairman
- Complete 4 convergence projects with IASB
  - Leasing, revenue recognition, financial instruments, insurance
- Incorporate IFRS into U.S. GAAP over time
- FASB stay activity involved with IASB/IFRS
- Keep the label U.S. GAAP

Private Company Accounting

- Sentiment that FASB not responsive to needs of non-public entities
- Past attempts to create a “GAAP Lite” or “Little GAAP” for smaller entities not successful
- 2010 - Blue Ribbon Panel on Standard Setting for Private Companies (FAF, AICPA, NASBA)
  - 2011 - issued report that included recommendation for separate standard setting Board for private companies
- 2012 – FAF approves “Private Company Standards Improvement Council”

FASB Not-for-Profit Advisory Committee

- Started in September 2010
- Advise FASB on NFP issues
- Current projects to improve the financial reporting model
    - Reporting financial performance
    - “Telling the story”
    - Liquidity / financial health measures
- FASB has agreed to take these on as a project

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State and Local Tax Update

Agenda

- Overview of Washington Tax System
- Exemptions & Deductions Applicable to Healthcare Organizations
- Common Reporting Issues
- Property Tax Opportunity

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Overview of Washington Tax System

Overview of Washington Tax System

- Unlike the Federal Government, Washington State has no general tax exemption for nonprofits
- Major taxes –
  - Business and occupation (B&O) tax
  - Retail sales / use taxes
  - Real and personal property taxes
  - City taxes

Business & Occupation Tax

- Nature of the tax
  - Business privilege tax
  - Imposed on all business activity
  - Not a net income tax (no deductions for the cost of doing business)
- Classifications
  - Determined based on nature of activity
  - Over 50 classifications
  - Different measure (tax base) and tax rate

Business & Occupation Tax

- Common classifications
  - Retailing
    - Gross proceeds of sale / .471%
  - Wholesaling
    - Gross proceeds of sale / .484%
  - Manufacturing
    - Value of products manufactured in Washington / .484%
  - Service & Other
    - Gross income of the business / 1.8%
  - Public & Nonprofit Hospitals
    - Gross Income of the business / 1.5%

Common B&O Tax Misconceptions and Traps

- Double taxation
  - Tax applies to transactions at multiple levels (i.e., tax pyramids)
  - Tax applies to all transactions between “persons” (no intercompany exemption / elimination)
- Broad definition of engaging in business
- Form of transaction controls (rather than substance)
- Advances and reimbursements

Sales Tax

- Tax on sales of tangible personal property and specific services
- Imposed on the consumer (end user)
- Collected by the seller who is liable if fails to collect
- Purchases for resale – reseller permits

Common Sales Tax Exemptions

- Sale for resale
- Certain items dispensed/administered pursuant to a prescription
  - Medicines and other substances for use in the diagnosis, cure, mitigation, treatment or prevention of disease in humans
  - Lenses and eyeglass frames
  - Orthotic devices
  - Medical oxygen
- Prosthetic devices
- Hearing aids
- Ostomic items
- Laboratory reagents and other diagnostic substances used in a test prescribed to diagnose disease in humans

Use Tax

- Companion to sales tax – same rate
- Everyone owes use tax on property purchased for use in the state when no sales tax is collected by the seller
- Use tax is not due on donated items
  - Donor also exempt

Property Tax

- All property is assumed to be taxable unless a specific exemption exists
- Exemptions are construed narrowly in favor of taxation
- Exemption statutes are drafted broadly, the Department of Revenue is charged with administering the exemption including disseminating the exemption for taxpayers

Property Tax – Exemption Process

1. Taxpayer files application for exemption
2. Department of Revenue evaluates qualification
3. Department schedules a field visit
4. Determination letter is issued and forwarded to the county to update the tax rolls
5. Exemption generally becomes effective for taxes due in the year following application

General Conditions for Exemption

- Exclusive use for the exempt purpose required
- Strict limits on the loan or rental of exempt property
- Irrevocable dedication to the exempt purpose required (exception for leased property)
- No discrimination is allowed for services provided
- Must comply with licensing and inspection requirements

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B&O Tax Exclusions, Exemptions & Deductions

B&O Tax Deductions, Exemptions, Exclusions for All Taxpayers

- Wages
- Investment income
- Real estate exemption
- Donations, contributions and endowments
- Fundraising
- Bad debts
- Discounts
- Advances and reimbursements

Healthcare Exclusions, Exemptions & Deductions

- Health or social welfare services deduction
  - Applies to public and nonprofit hospitals
  - A nonprofit hospital must be a “health or social welfare organization” (HSWO)
    - Must meet certain organizational requirements
    - Governing board of at least 8 members
    - No employee may be a paid member of the board
  - Applies to payments received directly from federal, state or local governmental entities to provide health or social welfare services

Healthcare Exclusions, Exemptions & Deductions

- Health or social welfare services (continued)
  - Deduction includes
    - Medicare, Medicaid, basic health and similar programs
    - Champus / Tricare
    - Indian Health
    - Department of Corrections / Bureau of Prisons
  - Does not include amounts received under an employee benefit plan

Healthcare Exclusions, Exemptions & Deductions

- Federal Medicare, Medicaid and similar programs administered by the State
  - Applies to public / nonprofit hospitals and nonprofit community health centers
  - Nonprofit organization must qualify as a HSWO
  - Payments may be received from an intermediary
  - Deduction doesn’t apply to patient copays or patient deductibles

Healthcare Exclusions, Exemptions & Deductions

- Nonprofit organizations operating kidney dialysis facilities
  - Fees for kidney dialysis service
  - Sales of prescription drugs dispensed as an integral part of dialysis service
- Amounts received by blood, tissue, or blood and tissue banks
  - IRC 501(c)(3) organization
  - Primary purpose requirement
  - Registered under 12 CFR, parts 607 and/or 1271

Healthcare Exclusions, Exemptions & Deductions

- Qualified organ procurement organization
  - Defined in 42 USC Sec 273(b)
  - Exempts all amounts received that are exempt from federal income tax.
- Charges for certain prescription drugs
  - Infusion or injection by licensed physician or agent
  - Separately stated charge on billing statement
  - Doesn’t exceed federal reimbursement rate
  - Covered under a plan subsidized by federal or state government

Healthcare Exclusions, Exemptions & Deductions

- Safe patient handling credit
  - Mechanical lifting devices and other devices primarily used to minimize patient handling
  - Part of a safe patient handling program developed and implement under state law
  - Credit equal to cost of purchased item
  - Available on first-in-time basis ($10 million statewide)
  - Take on return (no interest or penalty if maximum exceeded if paid by due date of notice)

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Common B&O Tax Reporting Issues

Common B&O Tax Reporting Issues

- Contractual adjustments
  - Contractual adjustments are an allowable deduction from gross patient revenue
  - Difficulties with the adjustment:
    - Accounting for subsequent adjustments to revenue that are presented in gross
    - Timing issues caused by reimbursements received in subsequent periods
    - Accounting for changes in reimbursement rates or differences in actual reimbursement

Common B&O Tax Reporting Issues

- Proper classification
  - Public or nonprofit hospitals
    - Lower rate applies only to providing personal or professional services to inpatients
    - Clinics and departments providing outpatient and inpatient services are eligible only when the clinic or department is an “integral, interrelated, and essential part of the hospital.”
    - Factors include location of the clinic or department and whether it furnishes services of a type normally provided by hospitals (24 hour intake and emergency services)

Common B&O Tax Reporting Issues

- Proper classification (continued)
  - Public or nonprofit hospitals
    - Educational programs and services
    - Must be integral, interrelated and essential to the hospital (unique and incidental to the provision of hospitalization services – difficult or impossible to duplicate by a person other than a hospital due to specialized knowledge, facilities or equipment)
  - With the rate differential between the hospital rate (1.5%) and the service rate (1.8%) this is likely to get closer scrutiny on audit.

Common B&O Tax Reporting Issues

- Proper classification (continued)
  - Service classification
    - Income from intercompany services (data processing, management fees, legal, tax, and HR)
    - Interest on accounts receivable
    - Transcription fees
    - Income from licenses to use real property
    - Other miscellaneous income not classified elsewhere

Common B&O Tax Reporting Issues

- Proper classification (continued)
  - Retailing
    - Sales of tangible personal property
    - Sales of meals (except to patients)
  - Manufacturing
    - Internal printing of invoices, letterhead, envelopes, etc.

Common B&O Tax Reporting Issues

- Grants / Contributions
  - Is it a gift?
  - Is there a quid pro quo?
  - Is there a special B&O classification?
- Fund raising activities
  - Organizational requirements
  - No regular place of business

Common B&O Tax Reporting Issues

- Investment Income
  - What's an investment?
  - Debt securities v. loans
- Multi-entity Organizations
  - Intercompany charges
  - Cash management
  - Common paymaster

B&O Tax Rules of Thumb

- Assume all activities are taxable;
- Determine the characteristics of receipts (i.e., retailing, wholesaling, or services);
- Determine whether a specific exemption, exclusion or deduction applies to an activity; and
- Collect or give any documentation required to establish an exemption.

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Property Tax

Hospital Exemption

- The real and personal property used by, and exclusively for the purposes of, non-profit hospitals for the sick is exempt from property taxation.
  - Recent changes are a change in the Department of Revenue's interpretation, not a change in statute

What is a Hospital?

Two Board of Tax Appeals cases

- Legacy Salmon Creek Hospital v. State of Washington, Department of Revenue (2007)
- Franciscan Health System v. State of Washington, Department of Revenue (2008)

What is a Hospital -The Old Test

- Does the facility provide a ‘hospital’ service?
- Does the facility regularly keep patients for periods greater than 24 hours?

What is a Hospital -The New Test

- Is the facility licensed as an acute care facility?
- Is the facility a fully integrated with an acute care facility?

How to Evaluate Qualification Under the New Rules

- Is the facility listed in Section 2, 'Facilities', of an acute care hospital license with DOH?
- Is the facility a fully integrated unit of the hospital?
  - 'Provider based' reimbursement rates
  - Integrated financial operations
  - Integrated clinical services
  - Held out to the public as part of the hospital

How to Take Advantage of Opportunities

- Get organized
- File an application for exemption with the Department of Revenue
- Prepare supplemental documents
- Decide whether it's a late application or a prospective application

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Questions?

Bob Heller
bheller@clarknuber.com
425.635.7424

Andrew Prather
aprather@clarknuber.com
425.635.4571