

EPAct Tax Aspects of Not-for-Profit Hospital Acquisitions

By Charles Goulding, Joseph Most and Spencer Marr

Charles Goulding, Joseph Most and Spencer Marr explain that recent healthcare legislation has resulted in the acquisition of not-for-profit hospitals by for-profit healthcare systems and private equity firms. Such acquisitions provide the opportunity to turn old, energy-inefficient not-for-profit hospitals into modern, energy-efficient facilities able to measurably increase profit by reducing energy-related operating costs.

Introduction

Since the enactment of the recent healthcare legislation, for-profit healthcare systems and private equity firms have been acquiring not-for-profit hospitals throughout the country. Often times, these acquisitions provide the opportunity to turn old, energy-inefficient not-for-profit hospitals into modern, energy-efficient facilities able to measurably increase profit by reducing energy-related operating costs. Private firms like Vanguard Systems, Cerberus, Lifepoint and Ardent—all in the process of acquiring not-for-profit hospitals—have stated their intention to make major capital improvements to these hospitals. Since hospitals are one of the most energy-intensive building categories, these private health systems providers should consider upgrading their lighting, heating and cooling systems, building envelope, lab equipment, laundry equipment and kitchen equipment to make them more energy-efficient. Many of these capital improvements are potentially eligible to receive major tax deductions through the federal EPAct legislation and save significant energy costs.

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EPAct Tax Deductions

Pursuant to Code Sec. 179D, as enacted by the Energy Policy Act (EPAct) of 2005,¹ hospital owners making qualifying energy-reducing investments can obtain immediate tax deductions of up to \$1.80 per square foot.

If the building project doesn't qualify for the maximum \$1.80 per square foot immediate tax deduction, there are tax deductions of up to \$0.60 per square foot for each of the three major building subsystems: lighting, HVAC (heating, ventilating and air conditioning) and the building envelope. The building envelope is every item on the building's exterior perimeter that touches the outside world including roof, walls, insulation, doors, windows and foundation.

Hospital Background

As a group, hospitals are well behind other building categories in addressing energy reduction. By some estimates, these private firms can realize up to a 15-percent increase in operating profits from energy savings.² Unlike most other capital improvements, energy retrofits qualify for tax incentives and utility rebates while saving energy costs over the lifetime of the technologies.

Chart 1 provides some examples of recent acquisitions of not-for-profit hospitals by for-profit health care systems providers, along their stated commitments to capital improvement projects.

Chart 1.

Recent Hospital Acquisition	Capital Improvement Commitments
Vanguard DMC	\$850 Million over 5 years
Cerberus Caritas Christi	\$400 Million over 4 years
Lifepoint Clark	\$60 Million for new hospital facility
Community Marion	\$50-70 Million over 5 years

EPAct Lighting Tax Opportunities

EPAct lighting deductions are based on reductions of energy use below wattage levels provided in ASHRAE 90.1, 2001, which sets wattage target rates for various categories of buildings. For a reduction in lighting power density of 25 percent below the requirements of ASHRAE 90.1, 2001, a facility is eligible for a deduction of 30 cents per square foot for the space where the upgrade took place. As the reduction in lighting power density increases, the deduction also rises, reaching a maximum of 60 cents per square foot for a 40-percent reduction in lighting power density. The maximum 60 cent per square foot lighting deduction is typically achievable by installing highly energy efficient LED, fluorescent

or induction lighting in place of existing incandescent or metal halide bulbs.

EPAct HVAC/Building Envelope Tax Opportunities

EPAct tax deductions of up to 60 cents per square foot are also available for both the HVAC system and the building envelope if an investment into either system reduces total building energy cost by at least 16.67 percent as compared to ASHRAE 90.1, 2001. Since a hospital is a facility commercial property category where patient comfort (air-conditioning or heating) needs to be provided 24/7, HVAC is one of the biggest hospital energy needs. To cool the building, hospitals often use chillers. If the hospital is less than 150,000 square feet, then the installed energy efficient chiller will most likely trigger an EPAct HVAC tax deduction.³ Hospitals exceeding 150,000 square feet that use very efficient HVAC system types, such as geothermal heat pumps or thermal storage, will typically generate large EPAct HVAC tax deductions.⁴

An estimate of the potential EPAct tax benefits available to both the recently announced not-for-profit hospital acquirers and acquirees facilities is presented in Chart 2.

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Chart 2.

EPAct Potential Tax Deductions Pre & Post Recent Hospital Mergers				
Acquiring Company	Vanguard Health Systems	Cerberus Capital Management	Lifepoint Hospitals	Community Health Systems
Pre-Acquisition Square Footage	4,000,000	N/A	5,500,000	18,000,000
60 cent per square foot deduction	\$2,400,000	N/A	\$3,300,000	\$10,800,000
\$1.20 per square foot deduction	\$4,800,000	N/A	\$6,600,000	\$21,600,000
\$1.80 per square foot deduction	\$7,200,000	N/A	\$9,900,000	\$32,400,000
Acquired Hospital/System	Detroit Medical Center	Caritas Christi Healthcare	Clark Regional Medical Center	Marion Regional Healthcare System
Acquired Hospital/System Square Footage	2,000,000	1,500,000	132,000*	215,000
60 cent per square foot deduction	\$1,200,000	\$900,000	\$79,200	\$129,000
\$1.20 per square foot deduction	\$2,400,000	\$1,800,000	\$158,400	\$258,000
\$1.80 per square foot deduction	\$3,600,000	\$2,700,000	\$237,600	\$387,000
Post-Acquisition Square Footage	6,000,000	1,500,000	5,632,000	18,215,000
Post-Acquisition Maximum EPAct Deduction	\$10,800,000	\$2,700,000	\$10,137,600	\$32,787,000

*Actual hospital size is 100,000 square feet, 132,000 square feet represents the size of the new facility as part of the acquisition agreement.

**Square footages are approximate

Wisconsin

A nonresident member of an LLC operating in Wisconsin did not owe the state's personal income tax on his distributive share of LLC income because the income retained its character as personal services income. Wisconsin Department of Revenue Publication 119 provides that LLC income derived from personal services is not taxable to a nonresident member unless the nonresident member personally performs services in Wisconsin.

All of the LLC's income was personal services income, but the taxpayer did not perform any services for the LLC. Since the taxpayer did not perform services for the LLC, the department argued that the LLC income lost its character as personal services income and became business income taxable in Wisconsin.

The Tax Appeals Commission concluded that the applicable law was ambiguous and explained that Wisconsin generally followed federal law. Since Code Sec. 702(b) provides that income passed through a partnership retains its character, the commission concluded that the income was properly characterized as personal services income and exempt from tax.¹⁰

New law (Act 3) creates a relocated business credit. Specifically, businesses that relocate to Wisconsin from another state and begin operations in Wisconsin may claim a credit for their Wisconsin income and franchise taxes, computed after applying all other credits, deductions and exclusions, for two consecutive tax years. Partnerships, LLCs and tax-option (S) corporations may not claim the credit; however, their partners, members and shareholders may. Persons that did business in Wisconsin during any of the 10 tax years preceding the tax year are not

eligible to claim the credit. While the credit is nonrefundable, unused credits may be carried forward.¹¹

ENDNOTES

¹ Cal. FTB, Legal Ruling 2011-01 (Jan. 11, 2011).

² Cal. FTB, Notice 2011-01 (Jan. 6, 2011).

³ *In re Rio Doce Ltd.*, No. 402204 (Cal. St. Bd. of Equal. Nov. 17, 2010).

⁴ Iowa Dept. of Rev., Ruling No. 10240041 (Dec. 16, 2010).

⁵ *Kimberly-Clark Corp. v. Comm. of Rev.*, No. C282754 (Mass. App. Tax. Bd. Jan. 31, 2011).

⁶ *Sherwin-Williams Co. v. Comm. Of Rev.*, 438 Mass. 71 (Mass. Sup. Ct., 2002).

⁷ *International Business Machines Corporation v. Dir., Div. of Taxation, and Crestron Electronics, Inc. v. Dir., Div. of Taxation*, Nos. 011630-2008 and 011795-2009 (N.J. Tax Ct. Jan. 26, 2011).

⁸ N.Y. Dept. of Tax. and Fin., TSB-A-11(1)C (Dec. 28, 2010).

⁹ *Lamtec Corp. v. Washington Dept. of Rev.*, No. 83579-9 (Wash. Sup. Ct. Jan. 20, 2011).

¹⁰ *Murphy v. Wis. Dept. Rev.*, Nos. 09-I-134 and 09-I-142 (Wis. Tax App. Comm. Dec. 30, 2010).

¹¹ Wis. Laws 2011 (Jan. 2011 Special Session), Act 3 (A.B. 3), enacted Jan. 31, 2011.

International Tax

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4. The additional one-time penalty on the highest account/asset value during the eight-year period has been increased to 25 percent (from 20 percent under the prior program).
5. The IRS has also retained a special five-percent rate if certain conditions are met. In addition, a new 12.5-percent rate applies to accounts or asset values that at all times during the covered period were not in excess of \$75,000.
6. The new program, and all of its terms, will apply to all new persons making voluntary disclosure before August 31, as well as to all those who made voluntary disclosure after the first program ended in October of 2009.

7. There is a slightly revised procedure for making voluntary disclosures, which is intended to streamline and centralize the process.

A more detailed International Tax Advisory on the new Offshore Voluntary Disclosure Initiative is forthcoming.

Hospital Acquisitions

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LEED Hospitals

Projects that are LEED-certified are naturally platformed for tax savings, because energy efficiency is the most weighted sustainable building feature in the LEED rating system. Leadership in Energy and Environmental Design (LEED) is the fast-growing marquee standard for sustainable buildings. Established by the U.S. Green Building Council (USGBC), LEED's four certification achievements start at the LEED-certified level and proceed to the higher levels of silver, gold and platinum. Most excitingly, the latest edition of the LEED certification program specifically recognizes hospitals as a distinct building category and sets specific guidelines for achieving maximum energy efficiency. In addition, LEED buildings have already been modeled with a building energy simulation model, which can be adjusted to fit the EPA energy simulation model required for a whole building (maximum \$1.80 per square foot) EPA tax deduction.⁵

Conclusion

A hospital without capital is "like a person in cardiac arrest," unable to compete in an increasingly competitive and fast-changing arena, says Jim

Unland, president of Health Capital Group in Chicago and the editor of the *JOURNAL OF HEALTH CARE FINANCE*.⁶ One of the simplest, most effective ways of reducing the operating cost of hospitals is the energy cost reduction. By reducing the amount of energy use, hospital owners can increase their operating profits. Since most of the major private hospital acquirers have already pledged major post acquisition capital improvement projects, this is the opportune time to consider energy efficiency. The savvy acquirers can use EPAAct to incentivize the promised capital upgrades and then apply the same opportunities to their existing facilities.

ENDNOTES

- ¹ Energy Policy Act (EPAAct) of 2005 (P.L. 109-58).
- ² See Charles Goulding, Jacob Goldman and Malcolm Thomas, *Lighting Upgrades May Bring Tax Savings for Hospitals*, *BUILDING OPERATIONS MGMT.*, Mar. 2010, at 35.
- ³ See Charles Goulding, Jacob Goldman and Joseph Most, *The Energy Tax Aspects of Chillers*, *CORP. BUS. TAX'N MONTHLY*, Oct. 2010, at 15.
- ⁴ See Charles Goulding, Raymond Kumar and Kenneth Wood, *New Efficient HVAC Drives Large Tax Deductions for Buildings*, *CORP. BUS. TAX'N MONTHLY*, May 2009, at 11.
- ⁵ See Charles Goulding, Taylor Goulding and Amelia Aboff, *How LEED 2009 Expands EPAAct Tax Saving Opportunities*, *CORP. BUS. TAX'N MONTHLY*, Sep. 2009, at 11.
- ⁶ See Jenny Gold, *Mergers of for-profit, non-profit hospitals: Who does it help?*, *USA TODAY*, Jul. 2010 www.usatoday.com/money/industries/health/2010-07-13-hospitalmergers13_CV_N.htm.

Interview with Ian Cremer

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sharing information and knowledge to the greatest extent possible. The fact that 2011 will be celebrated by the WCO and the wider Customs community

as the Year of Knowledge with the theme "Knowledge, a catalyst for Customs excellence" makes this interview even more opportune. Thanks for giving me the opportunity to share some of my thoughts with your readers.

ENDNOTES

- ¹ Valuation page available online at www.wcoomd.org/home_valoverviewboxes.htm.

Japanese Pricing

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include substantial changes in market prices. In the event that such changes in circumstances could occur, the taxpayer must change the conditions on which the taxpayer relies. In such circumstances, it is no longer appropriate to continue the APA in unmodified form. For this reason, the taxpayer should set up its critical assumptions, *i.e.*, the material and business conditions essential to the APA. The taxpayer should attach documents describing these conditions with the APA document request pursuant to Administrative Guidelines 5-3(c).

It is difficult for the taxpayer to exhaustively predetermine the factors that might affect the continuation of an APA. As such, it is common for the taxpayer to attach generic conditions to the APA request. Such a general condition could include, for example, the requirement that there should be "no material changes in business conditions or in economic conditions." Similarly, the general condition could include, for example, "the requirement that they have made no specific fundamental

changes in the functions performed by the related parties or the assets they have utilized." However, the parties may need to attach more specific conditions in some cases, such as to preclude a change beyond a certain range in exchange rates. The taxpayer might provide such a proviso in order to make clearly predictable whether a situation corresponds to the conditions established as critical assumptions.

Changes might occur in the changes the critical assumptions prescribe. In the event that such changes occur, it is necessary for the taxpayer to consider its calculation of the arm's-length price as to situation in question. As a rule, the confirmed corporation will have to apply for an amendment of the APA pursuant to Administrative Guidelines 2-10. This amendment process is mandatory. The failure to apply for an application invalidates the APA from the tax years in which the situation arose pursuant to Administrative Guidelines 5-21(1)(a).

In the case of an APA that has a mutual agreement, the tax authorities must initiate the mutual agreement procedure and take into account an agreement the tax authorities reached on a method of calculating the arm's-length price that differs from the initial method.

The confirmed corporation is to enter and submit a report for each tax year. That report provides a "statement of changes to changes to business conditions or to economic conditions," based on whether the government provides the taxpayer with the APA pursuant to Administrative Guidelines 5-17.