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the prospective payment system under part 419 of this chapter is implemented.

(b) For purposes of determining the blended payment amounts of ambulatory surgical center approved surgical procedures performed in the hospital outpatient setting under § 413.118 and hospital outpatient radiology services and other diagnostic procedures under § 413.122, the reduction is applicable only to the hospital-specific portion of the blended payment amounts.

[57 FR 36017, Aug. 12, 1992, as amended at 59 FR 26960, May 25, 1994; 62 FR 46037, Aug. 29, 1997; 65 FR 18542, Apr. 07, 2000]

§ 413.125 Payment for home health agency services.

(a) For additional rules on the allowability of certain costs incurred by home health agencies, see §§ 409.46 and 409.49(b) of this chapter.

(b) The reasonable cost of outpatient rehabilitation services furnished by a home health agency to homebound patients who are not entitled to home health benefits may not exceed the amounts payable under the physician fee schedule for comparable services effective January 1, 1999.

[59 FR 65497, Dec. 20, 1994, as amended at 63 FR 58910, Nov. 2, 1998]

Subpart G—Capital-Related Costs

§ 413.130 Introduction to capital-related costs.

(a) *General rule.* Capital-related costs and an allowance for return on equity are limited to the following:

(1) Net depreciation expense as determined under §§ 413.134, 413.144, and 413.149, adjusted by gains and losses realized from the disposal of depreciable assets under § 413.134(f).

(2) Taxes on land or depreciable assets used for patient care.

(3) Leases and rentals, including license and royalty fees, for the use of depreciable assets or land, as described in paragraph (b) of this section.

(4) The costs of betterments and improvements as described in paragraph (c) of this section.

(5) The costs of minor equipment that are capitalized, rather than expensed, as described in paragraph (d) of this section.

(6) Insurance expense on depreciable assets, as described in paragraph (e) of this section.

(7) Interest expense as determined under § 413.153, subject to the qualifications of paragraph (f) of this section.

(8) For certain proprietary providers, return on equity capital, as determined under § 413.157.

(9) The capital-related costs of related organizations (as described in § 413.17), as determined in accordance with paragraph (g) of this section.

(10) Debt issuance costs, debt discounts, and debt redemption costs, if the associated debt was incurred to acquire land or depreciable assets used for patient care or to refinance existing debt for which the original purpose was to acquire land or depreciable assets used for patient care.

(11) The apportionment of the capital-related costs of jointly owned assets among the owners must be on a basis that reflects the relative use by each owner, rather than the ownership share or the amount of time the asset is located at each owners site.

(b) *Leases and rentals.* (1) Subject to the qualifications of paragraphs (b) (2), (4), (5), and (8) of this section, leases and rentals, including licenses and royalty fees, are includable in capital-related costs if they relate to the use of assets that would be depreciable if the provider owned them outright or they relate to land, which is neither depreciable nor amortizable if owned outright. The terms “*leases*” and “*rentals of assets*” signify that a provider has possession, use, and enjoyment of the assets.

(2) For sale and leaseback agreements for hospitals and SNFs entered into before October 23, 1992 and for sale and leaseback agreements for other providers entered into at any time, a provider may include incurred rental charges in its capital-related costs, as specified in a sale and leaseback agreement with a nonrelated purchaser (including shared service organizations not related within the meaning of § 413.17) involving plant facilities or equipment only if the following conditions are met:

(i) The rental charges are reasonable based on the following—

(A) Consideration of rental charges of comparable facilities and market conditions in the area;

(B) The type, expected life, condition, and value of the facilities or equipment rented; and

(C) Other provisions of the rental agreements.

(i) Adequate alternative facilities or equipment that would serve the purpose are not or were not available at lower cost.

(ii) The leasing was based on economic and technical considerations.

(3) If the conditions of paragraph (b)(2) of this section are not met, the amount a provider may include in its capital-related costs as rental or lease expense under a sale and leaseback agreement may not exceed the amount that the provider would have included in its capital-related costs had the provider retained legal title to the facilities or equipment, such as interest on mortgage, taxes, depreciation, and insurance costs.

(4) For sale and leaseback agreements for hospitals and SNFs entered into on or after October 23, 1992, the amount a provider may include in its capital-related costs as rental or lease expense may not exceed the amount that the provider would have included in its capital-related costs had the provider retained legal title to the facilities or equipment, such as interest expense on mortgages, taxes, depreciation, and insurance costs (the costs of ownership). This limitation applies both on an annual basis and over the useful life of the asset.

(i) If in the early years of the lease, the annual rental or lease costs are less than the annual costs of ownership, but in the later years of the lease the annual rental or lease costs are more than the annual costs of ownership, in the years that the annual rental or lease costs are more than the annual costs of ownership, the provider may include in capital-related costs annually the actual amount of rental or lease costs. The aggregate rental or lease costs included in capital-related costs may not exceed the aggregate costs of ownership that would have been included in capital-related costs over the useful life of the asset had the

provider retained legal title to the asset.

(ii) If in the early years of the lease, the annual rental or lease costs exceed the annual costs of ownership, but in the later years of the lease the annual rental or lease costs are less than the annual costs of ownership, the provider may carry forward amounts of rental or lease costs that were not included in capital-related costs in the early years of the lease due to the costs of ownership limitation, and include these amounts in capital-related costs in the years of the lease when the annual rental or lease costs are less than the annual costs of ownership.

(iii) In any given year the amount of actual annual rental or lease costs plus the amount carried forward to that year may not exceed the amount of the costs of ownership for that year.

(iv) In the aggregate, the amount of rental or lease costs included in capital-related costs may not exceed the amount of the costs of ownership that the provider could have included in capital-related costs had the provider retained legal title to the asset.

(5) For lease purchase transactions entered into before October 23, 1992, a lease that meets the following conditions establishes a virtual purchase:

(i) The rental charge exceeds rental charges of comparable facilities or equipment in the area.

(ii) The term of the lease is less than the useful life of the facilities or equipment.

(iii) The provider has the option to renew the lease at a significantly reduced rental, or the provider has the right to purchase the facilities or equipment at a price that appears to be significantly less than what the fair market value of the facilities or equipment would be at the time acquisition by the provider is permitted.

(6)(i) If a lease is a virtual purchase under paragraph (b)(5) of this section, the rental charge is includable in capital-related costs only to the extent that it does not exceed the amount that the provider would have included in capital-related costs if it had legal

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title to the asset (the cost of ownership), such as straight-line depreciation, insurance, and interest. A provider may not include in its capital-related costs accelerated depreciation in this situation.

(ii) The difference between the amount of rent paid and the amount of rent allowed as capital-related costs is considered a deferred charge and is capitalized as part of the historical cost of the asset when the asset is purchased.

(iii) If an asset is returned to the owner, instead of being purchased, the deferred charge may be included in capital-related costs in the year the asset is returned.

(iv) If the term of the lease is extended for an additional period of time at a reduced lease cost and the option to purchase still exists, the deferred charge may be included in capital-related costs to the extent of increasing the reduced rental to an amount not in excess of the cost of ownership.

(v) If the term of the lease is extended for an additional period of time at a reduced lease cost and the option to purchase no longer exists, the deferred charge may be included in the capital-related costs to the extent of increasing the reduced rental to a fair rental value.

(7) Amounts included in lease or rental payments for repair or maintenance agreements are excluded from capital-related costs. If no amount is identified in the lease or rental agreement for maintenance, the entire lease payment is considered a capital-related cost subject to the provisions of paragraph (b)(1) of this section.

(8) For lease purchase transactions entered into on or after October 23, 1992, a lease that meets any one of the following conditions establishes a virtual purchase:

(i) The lease transfers title of the facilities or equipment to the lessee during the lease term.

(ii) The lease contains a bargain purchase option.

(iii) The lease term is at least 75 percent of the useful life of the facilities or equipment. This provision is not applicable if the lease begins in the last 25 percent of the useful life of the facilities or equipment.

(iv) The present value of the minimum lease payments (payments to be made during the lease term including bargain purchase option, guaranteed residual value, and penalties for failure to renew) equals at least 90 percent of the fair market value of the leased property. This provision is not applicable if the lease begins in the last 25 percent of the useful life of the facilities or equipment. Present value is computed using the lessee's incremental borrowing rate, unless the interest rate implicit in the lease is known and is less than the lessee's incremental borrowing rate, in which case the interest rate implicit in the lease is used.

(9)(i) If a lease establishes a virtual purchase under paragraph (b)(8) of this section, the rental charge is includable in capital-related costs to the extent that it does not exceed the amount that the provider would have included in capital-related costs if it had legal title to the asset (the cost of ownership). The cost of ownership includes straight-line depreciation, insurance, and interest. For purposes of computing the limitation on allowable rental cost in this paragraph, a provider may not include accelerated depreciation.

(ii) The difference between the amount of rent paid and the amount of rent allowed as capital-related costs is considered a deferred charge and is capitalized as part of the historical cost of the asset when the asset is purchased.

(iii) If an asset is returned to the owner instead of being purchased, the deferred charge may be included in capital-related costs in the year the asset is returned.

(iv) If the term of the lease is extended for an additional period of time at a reduced lease cost and the option to purchase still exists, the deferred charge may be included in capital-related costs to the extent of increasing the reduced rental to an amount not in excess of the cost of ownership.

(v) If the term of the lease is extended for an additional period of time at a reduced lease cost and the option

to purchase no longer exists, the deferred charge may be included in capital-related costs to the extent of increasing the reduced rental to a fair rental value.

(vi) If the lessee becomes the owner of the leased asset (either by operation of the lease or by other means), the amount considered as depreciation, for the purpose of having computed the limitation on rental charges in paragraph (b)(9)(i) of this section, must be used in calculating the limitation on adjustments for the purpose of determining any gain or loss under §413.134(f) upon disposal of an asset.

(c) *Betterments and improvements.* (1) Betterments and improvements are changes which extend the estimated useful life of an asset at least two years beyond its original estimated useful life, or increase the productivity of an asset significantly over its original productivity.

(2) A provider must capitalize and prorate the costs of betterments and improvements over the remaining estimated useful life of the asset, as modified by the betterment or improvement.

(d) *Minor equipment.* A provider must include in its capital-related costs the costs of minor equipment that are capitalized rather than charged off to expense if—

(1) The net book value of minor equipment at the time the provider enters the program is prorated over three years (that is, one-third of the net book value is written off each year), and new purchases are also prorated over a 3-year period; or

(2) The cost of minor equipment is prorated over their actual useful lives.

(e) *Insurance.* (1) A provider must include in its capital-related costs the costs of insurance on depreciable assets used for patient care or insurance that provides for the payment of capital-related costs during business interruption.

(2) If an insurance policy also provides protection for other than the replacement of depreciable assets or to pay capital-related costs in the case of business interruption insurance, only that portion of the premium related to the replacement of depreciable assets or to pay capital-related costs in the

case of business interruption insurance is includable in capital-related costs.

(f) *Debt premiums and debt discounts.* Debt premiums or debt discount are applied as adjustments to capital-related costs if the associated debt is incurred for acquiring land or depreciable assets used for patient care or for refinancing existing debt for which the original purpose was to acquire land or depreciable assets used for patient care.

(g) *Interest expense.* (1) A provider must include in its capital-related costs interest expense, as described in §413.153, if such expense is incurred in—

(i) Acquiring land or depreciable assets (either through purchase or lease) used for patient care; or

(ii) Refinancing existing debt, if the original purpose of the refinanced debt was to acquire land or depreciable assets used for patient care.

(2) If investment income offset is required under §413.153(b)(2)(iii), only that portion of investment income that bears the same relationship to total investment income, as the portion of capital-related interest expense bears to total interest expense, is offset against capital-related costs.

(h) *Costs of supplying organizations—*

(1) *Supplying organizations related to the provider.* (i) If the supplying organization is related to the provider within the meaning of §413.17, except as provided in paragraph (g)(1)(ii) of this section, a provider's capital-related costs include the capital-related costs of the supplying organization.

(ii) If the costs of the services, facilities or supplies being furnished exceed the open market price, or if the provisions of §413.17(d) apply, no part of the cost to the provider of the services, facilities, or supplies are considered capital-related costs, unless the services, facilities, or supplies would otherwise be considered capital-related.

(2) *Supplying organizations not related to the provider.* If the supplying organization is not related to the provider within the meaning of §413.17, no part of the charge to the provider may be considered a capital-related cost (unless the services, facilities, or supplies are capital-related in nature) unless—

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(i) The capital-related equipment is leased or rented (as described in paragraph (b) of this section) by the provider;

(ii) The capital-related equipment is located on the provider's premises, or is located offsite and is on real estate owned, leased or rented by the provider; and

(iii) The capital-related portion of the charge is separately specified in the charge to the provider.

(i) *Costs excluded from capital-related costs.* The following costs are not capital-related costs. To the extent that they are allowable, they must be included in determining each provider's operating costs:

(1) Costs incurred for the repair or maintenance of equipment or facilities.

(2) Amounts included in rentals or lease payments for repair or maintenance agreements.

(3) Interest expense incurred to borrow working capital (for operating expenses).

(4) General liability insurance or any other form of insurance to provide protection other than for the replacement of depreciable assets or to pay capital-related costs in the case of business interruption.

(5) Taxes other than those assessed on the basis of some valuation of land or depreciable assets used for patient care. (Taxes not related to patient care, such as income taxes, are not allowable, and are therefore not included among either capital-related or operating costs.)

(6) The costs of minor equipment that are charged off to expense rather than capitalized as described in paragraph (d) of this section.

(7) The costs incurred for maintenance and repair insurance agreements (commonly referred to as maintenance agreements).

(j) *Reduction to capital-related costs.* (1) Except for sole community hospitals and critical access hospitals, the amount of capital-related costs of all hospital outpatient services is reduced by—

(i) 15 percent for portions of cost reporting periods occurring on or after October 1, 1989, through September 30, 1991; and

(ii) 10 percent for portions of cost reporting periods occurring on or after October 1, 1991 and until the first date that the prospective payment system under part 419 of this chapter is implemented.

(2) For purposes of determining the blended payment amounts for hospital outpatient services under § 413.118 and § 413.122, the reduction is applicable only to the hospital-specific portion of the blended amounts.

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§ 413.134 Depreciation: Allowance for depreciation based on asset costs.

(a) *Principle.* An appropriate allowance for depreciation on buildings and equipment used in the provision of patient care is an allowable cost. The depreciation must be—

(1) Identifiable and recorded in the provider's accounting records;

(2) Based on the historical cost of the asset, except as specified in paragraph (j) of this section regarding donated assets; and

(3) Prorated over the estimated useful life of the asset using—

(i) The straight-line method; or

(ii) Accelerated depreciation under a declining balance method (not to exceed double the straight-line rate) or the sum-of-the-years' digits method in the following situations:

(A) Depreciable assets for which accelerated depreciation was used for Medicare purposes before August 1, 1970, including those assets for which a timely request to change from straight-line depreciation to accelerated depreciation was received by an intermediary before August 1, 1970;

(B) Depreciable assets acquired before August 1, 1970, if no election to use straight-line or accelerated depreciation was in effect on August 1, 1970, and the provider was participating in the program on August 1, 1970;

(C) Depreciable assets of a provider if construction of such depreciable asset began before February 5, 1970, and the provider was participating in the program on February 5, 1970; or