A PULSE ON THE HEALTHCARE M&A MARKET

By Rick Schreiber

Generally speaking, many of us believe the merger and acquisition (M&A) market did not have much of a pulse during 2009. Items contributing to this perception were the Great Recession, the tightening credit market, the real estate market, and so on.

Interestingly, as it pertains to the middle market healthcare industry, the M&A pulse was quite rapid. The middle market healthcare industry was the only sector to experience growth in the number of transactions in 2009, increasing 20 percent compared to 2008 (Source: Dealogic). With that said, there was a modest decline in the total transaction value suggesting a lower middle market transaction dominance.

A strengthening stock market and normalizing credit condition, coupled with ample amounts of private equity capital, all suggest an even greater increase in healthcare deal activity during 2010. This includes a slight improvement in valuation. No one is quite sure of the effect the pending healthcare reform played on the 2009 healthcare M&A market. The same holds true for 2010; however, there is a presumption that once the healthcare reform dust settles the healthcare M&A pulse should continue to only get stronger. On a related note, according to BDO’s recent IPO Outlook Study, a strong majority of the capital markets executives at
leading investment banks expect to see an increase in healthcare related IPO’s during 2010. Healthcare was also one of the top four growth industries, the remaining three include technology, energy/natural resources and biotech.

For-profit entities involved with M&A transactions must bear in mind that there are new business combination accounting rules that took effect last year. The new rules are drastically different and will directly impact company earnings and transparency related to M&A transactions. Some of the more significant areas of change are as follows:

• Acquisition Costs
• Restructuring Costs
• In-Process Research & Development
• Defensive Assets (e.g., trade names, patents, etc.)
• Income Taxes
• Contingent Consideration
• Bargain Purchase
• Step Acquisitions

Because acquisition and restructuring costs must now be expensed as incurred, and are no longer considered to be part of the overall purchase price, company earnings will be negatively affected which will require an increase level of disclosure and transparency. In the area of income taxes, any subsequent adjustments to tax reserves outside the measurement period will now run through a company’s earnings. Previously, changes to tax reserves went against a company’s goodwill. For a variety of reasons, it is expected that bargain purchases (i.e., situations in which the acquirer pays less than the fair value of the net assets acquired) will be more common. Under the new rules, bargain purchase gains will be immediately recognized as a gain on the acquirer’s income statement. Previously, the bargain gain was allocated on a pro-rata basis against the acquired long-lived assets. Although this article does not further address all of the above listed items, there are significant changes in all of these areas. BDO welcomes any questions or requests related to the new business combination rules.

CHARITY CARE DEDUCTIONS AS A PERCENTAGE OF GROSS PATIENT REVENUE

Did you know based on a survey performed by Thomson Reuters, the level of charity care deductions to gross patient revenue for nonprofits has grown by approximately 34 percent from 2006 through 2009? For the same period charity care for public hospital companies only grew by 19 percent. Public hospital organizations still have a level of charity care deductions that surpasses the nonprofit sector.

Where does your facility stand?

<table>
<thead>
<tr>
<th>Year</th>
<th>Nonprofit</th>
<th>Public</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>1.84%</td>
<td>2.43%</td>
</tr>
<tr>
<td>2007</td>
<td>1.89%</td>
<td>2.47%</td>
</tr>
<tr>
<td>2008</td>
<td>2.35%</td>
<td>2.79%</td>
</tr>
<tr>
<td>2009</td>
<td>2.47%</td>
<td>2.88%</td>
</tr>
</tbody>
</table>

Data Source: Thomson Reuters
FY 2011 MEDICARE PAYMENT FOR SNFS:
THE GOOD, THE BAD AND THE UGLY

By Randy Severson

On July 16, 2010, the Centers for Medicare & Medicaid Services (CMS) issued its notice for comment with respect to prospective payment rates for skilled nursing facilities effective October 1, 2010. Although officially referred to as CMS-1338-NC, the notice could also be referred to as “the good, the bad and the ugly”.

The “good” news is that as anticipated, the notice provides for a market basket adjustment to rates effective October 1, 2010, of approximately 2.3 percent. This is good news given the state of Medicaid reimbursement across the country (see the Spring 2010 issue of BDO Knows: Healthcare newsletter) and that Medicare is not being nearly as nice to home care providers who are facing a 4.75 percent decrease in payments during calendar year 2011.

The “bad” news is that the market basket adjustment is being reduced by 0.6 percent due to a forecast error in establishing FY 2009 rates. When the actual change in market basket is different from that forecasted and used in establishing rates by more than 0.5 percent, subsequent rates are adjusted accordingly. Thus, the 0.6 percent downward adjustment to the FY 2011 market basket increase.

Before we get to the “ugly,” a little background information is warranted. Currently, each nursing facility resident’s clinical condition is evaluated using a resident assessment instrument, the MDS 2.0, which collects the clinical data used to determine the case-mix classification of a resident (and corresponding payment) under the RUG-III classification system. The RUG-III system has 53 payment classifications which were derived from time and motion studies performed during the 1990s. As outlined in the SNF PPS proposed rule for FY 2010, CMS collected data in 2006-2007 as a basis to update the case-mix classification system to take effect in FY 2011. The resulting RUG-IV case-mix classification system was finalized in the FY 2010 final rule to take effect concurrently with an updated resident assessment instrument, the MDS 3.0, which collects data used for the implementation of the new RUG-IV case-mix classification system. It is important to note that the RUG-IV system has 66 payment classifications.

Okay … now for the “ugly.” Thanks to the Patient Protection and Affordable Care Act (ACA) enacted on March 23, 2010, implementation of the RUG-IV case-mix classification system has been postponed until no earlier than October 1, 2011.

Notwithstanding the postponement of RUG-IV implementation, certain revisions of the overall RUG-IV system related to concurrent therapy and the look-back period are to be implemented October 1, 2010. In addition, implementation of MDS 3.0 is to take place effective October 1, 2010, as well. Herein lies the problem. While there is “grouper” software that links the MDS 2.0 to RUG-III and the MDS 3.0 to RUG-IV, there is no such software that incorporates the MDS 3.0 to the “hybrid” case-mix classification system (HR-III) now mandated to take effect October 1, 2010. So while CMS develops grouper software that links HR-III with the MDS 3.0, CMS will pay interim rates based on the MDS 3.0 and RUG-IV system which will then be retroactively adjusted once the HR-III/MDS 3.0 system has been developed. Effective October 1, 2011, CMS will then implement MDS 3.0 and RUG-IV as originally planned.

Implementation of MDS 3.0 and HR-III/RUG-IV are to be budget neutral. As a result, the net market basket increase of 1.7 percent on October 1, 2010, is not negatively impacted. However, it is important to note that once HR-III and RUG-IV are implemented, there will be significant shifts in payments across HR/RUG classifications.

Confused? You’re not alone! But don’t delay … time is ticking on the 60-day comment period which ends September 14, 2010.

For more information contact Randy Severson, Assurance Director, Healthcare Practice, at rseverson@bdo.com.
DOCUMENT CORRECTION PROGRAM FOR NON-QUALIFIED DEFERRED COMPENSATION SUBJECT TO IRC §409A

By Derrick Neuhauser and Yolanda Scannicchio

Many of our tax-exempt clients have long-standing executive directors who more than likely have Internal Revenue Code (IRC) Section (§) 457(f) plans, which allow tax-exempt organizations to provide non-qualified deferred compensation to a select group of management or highly compensated employees. IRC §457(f) and other non-qualified deferred compensation arrangements provided by both for-profit and tax-exempt organizations are subject to IRC §409A regulations. In Notice 2010-6, the Internal Revenue Service (IRS) announced a new document correction program for deferred compensation plans that violate IRC §409A.

On April 10, 2007, the final regulations under IRC §409A were announced and a deadline of January 1, 2009, was set for operational and documentary compliance. The final regulations are applicable to both for-profit and nonprofit organizations. IRC §409A generally provides for the acceleration of the recognition of income and imposition of an excise tax on participants in deferred compensation programs in those cases where the participant is deemed to have the ability to control the timing of the receipt of the deferred compensation. The IRS, recognizing that compliance with IRC §409A could be complicated, provided taxpayers with the ability to correct certain types of operational failures in Notice 2008-113; however, Notice 2008-13 did not give taxpayers the ability to correct failures in the underlying documents.

Although the nonprofit entity itself is not subject to IRC §409A, the officers of the organization are. Failure to comply could subject executives to immediate taxation, a 20 percent excise tax and interest penalties. As mentioned above, IRC §457(f) plans are regulated by IRC §409A. In addition, many nonprofit entities have other compensation arrangements that should be reviewed, such as bonus and incentive plans where the bonus is paid in the year after it was earned, severance arrangements, Supplemental Executive Retirement Plans (SERPs) and arrangements that provide for “gross-up” payments.

Notice 2010-6 gives a taxpayer the ability to bring its underlying plan documents into compliance with IRC §409A by December 31, 2010, so long as any operational issues are also corrected under Notice 2008-113. If the terms of Notice 2010-6 are satisfied, the Service will not impose the sanctions contained in IRC §409A. However, in certain cases, compliance with Notice 2010-6 will result in a reduced level of income recognition and related excise tax.

It is possible for the definition of certain terms in a plan to conflict with the definition of those terms in IRC §409A. The Notice gives the plan the ability to amend those terms (the IRS uses as examples the terms “change in control,” “disability,” and “separation from service”), although some of the amendments can be made only on a prospective basis. The Notice also indicates that certain ambiguous plan terms which are often found in the discussion of distributions from the plan, such as “as soon as reasonably practicable”, will not cause the plan to fail to satisfy section IRC §409A’s requirements if the plan, in operation, satisfies the terms of IRC §409A.

If a plan which fails to satisfy the requirements of IRC §409A is eligible for correction under Notice 2010-6, and the plan is corrected on or before December 31, 2010, the plan will be treated as having been corrected on January 1, 2009, and any requirement of income inclusion under IRC §409A as a condition of the relief will not apply. However, Notice 2010-6 also provides that this transition relief will apply only if any payment made before December 31, 2010, that would not have been made under the corrected provision, will be classified as an operational failure and thus subject to the provisions of Notice 2008-113. The benefits of Notice 2010-6 will not be available to taxpayers that are under examination on an IRC §409A-related issue.

While many nonprofit organizations have already undertaken plan reviews, there is value in making an additional review, particularly in light of the specific issues that have been addressed in Notice 2010-6. If violations are found, corrections can still be made before the end of this year to mitigate penalties.

Please contact the Compensation and Benefits practice if you have further questions. Derrick Neuhauser, Senior Manager, dneuhauser@bdo.com and Yolanda Scannicchio, Senior Associate, yscannicchio@bdo.com.
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