Tax Considerations For Medical Practices When Adopting EHR

By Mark A. Estroff, CPA

Introduction

Starting in 2011, qualified professionals can take advantage of financial incentives established by the Health Information Technology for Economic and Clinical Health Act (HITECH Act). These incentives take the form of enhanced reimbursements from Medicare and Medicaid to qualified professionals.

The primary goal of the federal government was to motivate healthcare professionals to make significant investment in medical technology, specifically Electronic Health Record (EHR) systems. As anticipated, many healthcare providers have invested in and upgraded their practice technology in order to participate.

In addition to the direct financial incentives provided in the HITECH Act, there are many tax incentives available to the healthcare professional to further mitigate the investment costs required to qualify for the enhanced Medicare and Medicaid reimbursement. This article addresses the tax incentives that are available to a healthcare professional when making investments in new technology whether in response to the HITECH Act or otherwise.

Components of an EHR System

Typically an EHR system is comprised of 4 primary components.

- **Software**-Although it often arrives in the office on 2 or 3 DVD’s, surprisingly enough, the software is usually the most significant cost component of the EHR system. Through either purchase or licensing, the costs can be extensive. Software, in the context of this analysis, is considered to be a proprietary and widely distributed application marketed by the software developer or its distribution network. It is not a custom application commissioned or developed for the user’s exclusive use. Merely, modifying or entering practice specific templates, names or processes does not convert an “off the shelf” application to a custom application. The tax incentives for custom designed software are beyond the scope of this document.

- **Hardware**-On the surface, the hardware components of an EHR system would seem easy to identify. The most obvious components are, of course, work stations or local PC’s, servers, switches, monitors, tablet PC’s, laptop PC’s, disk drives, uninterruptible power supplies, mice, keyboards, routers and so on. Shipping and installation costs are also considered part of the cost of the hardware. The not so obvious hardware costs are those related to modification of your office space to support the hardware.
• **Building improvements in support of the hardware** - Modifications to a healthcare professional’s office, traditionally classified as leasehold improvements, actually are considered as part of the equipment for tax purposes if the improvements support its operation. These types of modifications include communications cabling, specialized electrical wiring or modifications, ventilation or air conditioning and so on. The improvements must directly support and be made as a result of the EHR System.

• **Training costs**—if you are not purchasing or being provided training, you may want to evaluate your expectations for a successful implementation of your EHR system.

**Tax Benefits Available for EHR Investment**

**Depreciation**

Code Sections 167(a) and 167(a)(1) of the Internal Revenue Code state that “There shall be allowed as a depreciation deduction a reasonable allowance for exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business.”

In other words, a business is allowed to depreciate or “write-off” their investment in property used in their trade or business over a period of time which is generally the property’s useful life.

The methods of calculating and determining the depreciation deduction are subsequently described in Internal Revenue Code Section 168.

Specifically, computer hardware falls into the category designated as “5-year property”. This means that a practice’s investment in the hardware components of their EHR system can be depreciated over an Internal Revenue Service (IRS) specified life of 5 years. The method specified for such property is the accelerated depreciation method known as the 200 percent declining balance method (Internal Revenue Code Section 168(b)(1)(A) and 168(b)(1)(B)). This method allows for a rapid write-off of the cost of the investment with most of the tax benefits occurring in earlier years.

In addition to the direct hardware costs, modifications to the building made specifically to support the EHR system hardware such as computer equipment cooling power systems, data equipment electrical systems, data equipment grounding systems, data cabling, etc are also considered to be “5 year property” and as such qualify for the accelerated depreciation and the 5 year depreciation period. These costs are often overlooked for inclusion in the 5 year property classification and are often erroneously depreciated over time periods of either 15 or 39 years. Of course, all such qualifying building modifications should be carefully evaluated to ensure that they meet the appropriate qualifications for consideration as 5 year property that were outlined by the courts in HCA v. Commissioner 109 T.C. 21 (1997).
Software, generally, may be depreciated utilizing the straight line method over a useful life of 36 months (Internal Revenue Code Section 167(f)(1)(A)).

**Bonus Depreciation in the First Year**

If your EHR system is acquired after December 31, 2007 and before January 1, 2013, the 5 year property and software will also qualify for additional first year depreciation or “bonus depreciation” in addition to the otherwise allowable depreciation (Internal Revenue Code Section 168(k)). For qualified items, acquired after December 31, 2007 and before September 8, 2010 the bonus depreciation is equal to 50% of the cost of such items. The bonus depreciation rate for qualified property acquired after September 8, 2010 and placed in service before January 1, 2012 increases to 100%. For qualified items acquired after December 31, 2011 and before January 1, 2013 the bonus depreciation reverts back to 50% of the cost of such items. After bonus depreciation is taken, the remaining cost of the items is then depreciated using the methods described above.

For computer hardware it is possible to write-off as much as 60% of the investment in the first year when bonus depreciation of 50% and regular depreciation are combined. For the period after September 8, 2010 and before January 1, 2012, you can write-off 100% of the cost of your investment in the first year. In fact, this is the provision of the Internal Revenue Code referenced by President Obama in his recent State of the Union Address when he noted that “Every business can write off the full cost of the new investments they make this year.”

Between September 8, 2010 and January 1, 2013 and depending upon the timing, payment and financing of the EHR system, a practice could even have positive cash flow from the transaction in the first year after considering the tax benefits of the 100% bonus depreciation.

**Election to Expense EHR System—Internal Revenue Code Section 179**

Under Section 179 of the Internal Revenue Code, it gets even better. The hardware and software components of an EHR system could qualify for full expensing in the year placed in service should the election be made by the healthcare provider. In other words, if this election is available to a medical practice, 100% of the cost of the EHR system could be written off in the year it is placed in service.

Section 179 Expensing is available subject to the following limitations.

For taxable years beginning in 2010 or 2011, the maximum amount that can be expensed is $500,000.

For taxable years beginning in 2012, the maximum amount that can be expensed is $125,000, and for taxable years beginning after 2012, the limit drops down to $25,000.

Should a business's investment in qualified Section 179 property exceed $2,000,000 in 2010 or 2011, the limitations described above will be reduced by the amount of the investment that exceeds $2,000,000. This overall investment cap is $500,000 in 2012 and $200,000 thereafter.
Additionally, total section 179 expensing is limited to the taxable income for the taxable year before considering the section 179 expense.
**Bonus Depreciation or Section 179 Expensing**

Section 179 is an elective provision subject to the taxable income limitations described above and may therefore be limited in certain situations. Bonus depreciation is not subject to the total cost or taxable income limitations and is essentially unlimited.

If the section 179 expensing election is made for an asset, the amount of the asset’s cost subject to depreciation is reduced by the amount of the section 179 expense.

It should also be noted that some states are not following all federal bonus depreciation and Section 179 expensing rules so an adjustment may be necessary for state tax reporting.

As the depreciation, bonus depreciation rules and expensing rules are quite intricate and interrelated, professional tax advice should be sought to ensure the optimal elections and calculations are made for your practice’s unique situation. The good news, however, is that the tax benefits are available and can be crafted to fit the specific needs and tax strategies of your business.

**Lease or Purchase of an EHR System**

A practice is often faced with the opportunity to lease or purchase an EHR system. Small businesses often assume that the tax rules favor a lease. Sometimes aggressive sales consultants will reinforce that assumption as well without considering the global economic factors that are relevant.

More often than not, the true economics of the transaction determine the decision to purchase or lease equipment as the tax benefits are similar under either scenario, the decision is economic based, not tax based.

Leases of equipment can either be classified as a “Capital Lease” or as an “Operating Lease”.

An operating lease is merely the rental of the subject property. The lessee takes no title or ownership to the property and there is no bargain purchase of the property at the end of the lease. Operating leases are also usually fairly short term in nature. The lease payments are deductible as equipment rent and the depreciation and expensing rules do not apply. The tax benefits follow the actual rental payments. When most people hear the term “lease” they often associate it with an operating lease. Practically speaking, however, most leases of hardware and software are not operating leases; they are capital leases.

A capital lease is a transaction which for all practical purposes is considered to be a purchase or a financing transaction. The terms and economics of a capital lease are equivalent to a purchase with an installment loan. The word “lease” at the top of the document has no bearing on the tax treatment. A lease is categorized by the facts and circumstances of the contract. The most significant components of a capital lease are the bargain purchase option at the end of the lease and the fact that the lease term is over a significant portion of the useful life of the property. In a capital lease scenario, all of the
depreciation and expensing elections previously discussed apply to the assets. The actual lease payments are treated like installment loan payments with a portion allocated to interest and a portion allocated to principal.

The tax treatment of a capital lease is no different than that of an outright purchase of property utilizing outside (bank or otherwise) financing. The real difference lies in the economics of the financing transaction.

Although not directly stated, a capital lease has an implied interest rate for the financing component. A simple present value analysis will be able to determine the implicit interest rate or cost of the financing for a capital lease. Most lessees would be surprised to find that they are often paying rates as high as credit cards to acquire their EHR system. Exhibits A and B show an example of a capital lease and an acquisition of the same equipment through a bank loan.

Exhibit A illustrates a lease of an EHR system with a fair market value of $60,000. The lease is for a 60 month period with monthly payments equal to $1,500. Upon acquisition of the system, the practice will pay a deposit of the first and last months’ lease payment or $3,000. At the end of the lease period the practice can purchase the equipment for 5% of its original cost or $3,000. In lieu of exercising the bargain purchase price, the practice can return the system to the leasing company. The total payments for the lease of an EHR system with a fair market value or cash price of $60,000 in Exhibit A is $93,000 with an implicit interest rate of 19.687%.

Exhibit B illustrates the purchase of the same $60,000 EHR system utilizing bank financing at an interest rate of 7.00%. Total payments for this alternative are $71,284.20, for a total savings of $21,715.80 over 60 months as compared to a lease. Furthermore, the monthly payment is only $1,188.07 under the bank financing scenario.

Under either scenario the total payment stream is deductible either through depreciation, Section 179 deductions or as interest expense, however, one option costs dramatically more than the other due to the interest rate differential. Establishing the true economics of the acquisition options as part of the process will potentially enable your practice to save significant money on the total implementation of an EHR system.

Although the true cost of acquiring the equipment acquired may be significantly greater when a capital lease is utilized there are often legitimate business reasons for choosing a lease. Most often a business will utilize a leasing transaction if it has limited access to credit or is not eager to tie up its current borrowing capacity from their bank. Businesses may also consider leasing because of relaxed or expedited credit underwriting, especially if the business has an adverse credit rating. Of course, this relaxed underwriting and perceived additional risk to the lender is reflected in the higher implicit interest rate. Occasionally, vendors will offer promotions or incentives for leases that truly contain favorable interest rates and an opportunity may exist to obtain an interest rate more favorable than a bank may offer.
Training Costs

A successful EHR deployment will require much training for the staff of a medical practice. Just booting up the software does not constitute a successful implementation. Training costs, both direct and indirect can be a substantial part of the EHR deployment budget.

Staff training costs are deductible for tax purposes as ordinary and necessary expenses of a business. The intangible benefit of efficient staff and a successful implementation through appropriate training is significant too.

State Tax Incentives for Training Costs

Fortunately many states provide grants and tax incentives to businesses who take the initiative to upgrade technology and workers’ skills.

Consult with your tax advisor, state department of revenue or state department of labor to determine which specific incentives are available in your unique situation. Although application and qualification for a credit or a grant may be time-consuming, the potential cost savings can be substantial.

Conclusion

Whether you are merely moving to the next logical stage of technology for your practice or entering the “modern era” altogether, direct financial and tax incentives can dramatically decrease the true cost of progress. As discussed above, the tax opportunities available for doing so are quite complex and the possibilities seem endless. With all of the tax options available, your practice can achieve optimal tax and cash flow results by evaluating them carefully and making the correct elections. Your practice should work closely with your practice Certified Public Accountant (CPA) to ensure that no tax opportunities are overlooked and that the best choices for your unique situation are made.

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Exhibit A - EHR System Lease

Compound Period: Monthly

Nominal Annual Rate: 19.687 %

Equipment Fair Market Value: $60,000  Monthly Payment: $1,500 for 60 Mos.

System can be acquired at end of lease for 5% of Value

CASH FLOW DATA

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AMORTIZATION SCHEDULE - Normal Amortization

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<td>93,000.00</td>
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Exhibit B - EHR System Bank Loan

Compound Period: Monthly
Nominal Annual Rate: 7.000 %
Borrow 100% of Cost; No Bargain Purchase

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AMORTIZATION SCHEDULE - Normal Amortization

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Last interest amount decreased by 0.10 due to rounding.