Tax Cuts & Jobs Act of 2017

What Does the Tax Reform Bill Mean for the Healthcare Industry?

Missouri Society of Certified Public Accountants

Health Capital Consultants

Presenter Bio

Todd A. Zigrang, MBA, MHA, FACHE, ASA is the President of **HEALTH CAPITAL CONSULTANTS** (HCC), where he focuses on the areas of valuation and financial analysis for hospitals, physician practices, and other healthcare enterprises. Mr. Zigrang has over 23 years of experience providing valuation, financial, transaction and strategic advisory services nationwide in over 2,000 transactions and joint ventures involving acute care hospitals and health systems; physician practices; ambulatory surgery centers; diagnostic imaging centers; accountable care organizations, managed care organizations, and other third-party payors; dialysis centers; home health agencies; long-term care facilities; and, numerous other ancillary healthcare service businesses. Mr. Zigrang is also considered an expert in the field of healthcare compensation for physicians, executives and other professionals.

Mr. Zigrang is the co-author of the "*Adviser's Guide to Healthcare – 2nd Edition*" (AICPA, 2015), numerous chapters in legal treatises and anthologies, and peer-reviewed and industry articles such as: *The Guide to Valuing Physician Compensation and Healthcare Service Arrangements* (BVR/AHLA); *The Accountant's Business Manual* (AICPA); *Valuing Professional Practices and Licenses* (Aspen Publishers); *Valuation Strategies*; *Business Appraisal Practice*; and, *NACVA QuickRead*. Additionally, Mr. Zigrang has served as faculty before professional and trade associations such as the American Bar Association (ABA); the National Association of Certified Valuators and Analysts (NACVA); Physician Hospitals of America (PHA); the Institute of Business Appraisers (IBA); the Healthcare Financial Management Association (HFMA); and, the CPA Leadership Institute.

Tax Cuts & Jobs Act of 2017

- Signed into law on December 22, 2017
- Brings non-profit entities more in line with their for-profit colleagues
- Corporate tax rate reduced from 35% to 21%
  - As a result, for-profit providers are anticipating tax reductions ranging between $10-500 million in 2018
  - Likely even more for pharmaceutical and health insurance companies
  - Only 21% of community hospitals owned by for-profit entities

"Seven key changes the new tax law will force hospitals to consider" By Harris Meyer, Modern Healthcare, http://www.modernhealthcare.com/article/20180102/NEWS/180109995 (Accessed 7/31/18). "Tax reform imposes costs on tax-exempt healthcare organizations as for-profit peers weigh benefits" PricewaterhouseCoopers LLP, February 2018, https://www.pwc.com/us/en/health-industries/health-research-institute/publications/impact-of-TCJA.html (Accessed 7/31/18). "New Excise Tax Cuts Into Tax-Exempt Executive Compensation" By Scott C. Withrow, Esq., ABA Health eSource, Vol. 14, No. 7.

Qualified Business Income (QBI)

- New Pass-Through Deduction for Qualified Business Income (QBI) – Section 199A
- Allows for an up to 20% deduction of QBI from:
  - Partnerships
  - Limited Liability Companies (LLCs)
  - S Corporations
  - Trusts
  - Estates
  - Sole Proprietorships
- Only applies to taxpayers with taxable incomes of less than $157,500 for single taxpayers and $315,000 for joint filers

"Mechanics of the new Sec. 199A deduction for qualified business income" By William A. Bailey, CPA, J.D., LL.M., Journal of Accountancy, May 1, 2018, https://www.journalofaccountancy.com/issues/2018/may/sec-199a-deduction-for-qualified-business-income.html (Accessed 9/6/18). "IRS issues proposed regulations on new 20 percent deduction for passthrough businesses" Internal Revenue Service, Press Release, August 8, 2018, https://www.irs.gov/newsroom/irs-issues-proposed-regulations-on-new-20-percent-deduction-for-passthrough-businesses (Accessed 9/17/18).

Qualified Business Income (QBI)

- "*Below the line*" deduction
- Based on an "*'artificial' calculation of business income instead of actual economic outlays required for most other business deductions*"
- Big tax benefit for non-corporate businesses
  - Included in the tax reform to equate non-corporation tax cuts with the cuts for C-Corps
  - Deduction taken at the following levels:
    - Partner
    - S-Corp Shareholder
    - Estate and Trust
    - Sole Proprietor
  - Effective beginning after December 31, 2017 (sunsets in 2026)

MOCPA Missouri Society of Certified Public Accountants

HCC Health Capital Consultants

Net Operating Loss (NOL) Changes

- Changes to the Net Operating Loss (NOL) carryover and carryback provisions
  - Statutory Definition: "*the excess of the deductions allowed by [Chapter 1, Subchapter B, of the U.S. Code] over the gross income*", i.e., the amount that business deductions exceed a taxpayer's gross income, "*subject to certain modifications*"
  - Historically, NOL carrybacks/forwards have been a means to treat taxpayers with different earning cycles, but similar annual income, in a more equitable manner

MOCPA Missouri Society of Certified Public Accountants

"Net operating loss deduction" 26 U.S.C. § 172(c) (2017). "Carry your losses (further) forward" By John Owsley, CPA, Ph.D., and John McKinley, CPA, CGMA, J.D., LL.M., Journal of Accountancy, May 1, 2018, https://www.journalofaccountancy.com/issues/2018/may/carry-forward-net-operating-losses.html (Accessed 9/6/18).

HCC Health Capital Consultants

Net Operating Loss (NOL) Changes

- Prior to the passage of the TCJA:
  - NOL could be "*carried back*" up to 2 tax years, and forward up to 20 years, to offset taxable income
- Under the TCJA:
  - "*There shall be allowed as a deduction for the taxable year an amount equal to the lesser of—*

    the aggregate of the net operating loss carryovers to such year, plus the net operating loss carrybacks to such year, or

    80 percent of taxable income computed without regard to the deduction allowable under this section"
- Meaning: "*NOLs can no longer be carried back but are allowed to be carried forward indefinitely*"
- Effective for NOLs occurring on/after January 1, 2018

MOCPA Missouri Society of Certified Public Accountants

"Carry your losses (further) forward" By John Owsley, CPA, Ph.D., and John McKinley, CPA, CGMA, J.D., LL.M., Journal of Accountancy, May 1, 2018, https://www.journalofaccountancy.com/issues/2018/may/carry-forward-net-operating-losses.html (Accessed 9/6/18). "Net operating loss deduction" 26 U.S.C. § 172(a) (2017).

HCC Health Capital Consultants

Net Operating Loss (NOL) Changes

- Corporations cannot take into account the new deduction for foreign-derived intangible income and global intangible low-taxed income
- For business taxpayers other than C-Corps, the new deduction under Section 199A qualified business income is not allowed in determining an NOL

Section 172(d)(9). "Carry your losses (further) forward" By John Owsley, CPA, Ph.D., and John McKinley, CPA, CGMA, J.D., LL.M., Journal of Accountancy, May 1, 2018, https://www.journalofaccountancy.com/issues/2018/may/carry-forward-net-operating-losses.html (Accessed 9/6/18).

Net Operating Loss (NOL) Changes

Potential Consequences:

- The reform "*will generally have the effect of increasing the present value of total federal income taxes owed*"
  - "*Taking into account the time value of money, companies with intermittent loss years and startup companies with initial years of losses may fare less well than under previous law, all other factors being equal*"
  - *"[G]enerally, the changes to the NOL rules put greater emphasis on taxpayers' understanding of the timing of their income and deductions when assessing expected future tax liabilities. A taxpayer can no longer rely on the NOL carryforward provisions to result in no federal tax liability in years of low taxable income relative to prior loss years"*

"Carry your losses (further) forward" By John Owsley, CPA, Ph.D., and John McKinley, CPA, CGMA, J.D., LL.M., Journal of Accountancy, May 1, 2018, https://www.journalofaccountancy.com/issues/2018/may/carry-forward-net-operating-losses.html (Accessed 9/6/18).

Net Operating Loss (NOL) Changes

Potential Consequences:

- May raise costs for tax-exempt providers, especially in urban markets
- May spin off some entities as separate taxable corporations (but may raise the eyebrows of federal and state regulators)

"Tax reform imposes costs on tax-exempt healthcare organizations as for-profit peers weigh benefits" PricewaterhouseCoopers LLP, February 2018, https://www.pwc.com/us/en/health-industries/health-research-institute/publications/impact-of-TCJA.html (Accessed 7/31/18).
"Seven key changes the new tax law will force hospitals to consider" By Harris Meyer, Modern Healthcare, http://www.modernhealthcare.com/article/20180102/NEWS/180109995 (Accessed 7/31/18).

Employee Benefits and Compensation

- No longer allowed to offset income from unrelated business activities, i.e., fringe benefits (e.g., cafeteria earnings, employer-provided parking, transit passes, shuttle busses and vans) with losses from other unrelated business activities

"Tax reform imposes costs on tax-exempt healthcare organizations as for-profit peers weigh benefits" PricewaterhouseCoopers LLP, February 2018, https://www.pwc.com/us/en/health-industries/health-research-institute/publications/impact-of-TCJA.html (Accessed 7/31/18).
"Seven key changes the new tax law will force hospitals to consider" By Harris Meyer, Modern Healthcare, http://www.modernhealthcare.com/article/20180102/NEWS/180109995 (Accessed 7/31/18).

Employee Benefits and Compensation

- Any amount spent on the provision of qualified transportation fringe to employees of tax-exempt organizations now subject to the *Unrelated Business Taxable Income* (UBTI)

- Whether, in what circumstances, and in what amounts, should expenses related to employee parking, transit, and commuter shuttles be included in UBTI?

MOCPA Missouri Society of Certified Public Accountants

New Code Sections 82, 132. Code Section 217 (moving deduction). "Tax reform imposes costs on tax-exempt healthcare organizations as for-profit peers weigh benefits" PricewaterhouseCoopers LLP, February 2018, https://www.pwc.com/us/en/health-industries/health-research-institute/publications/impact-of-TCJA.html (Accessed 7/31/18).

HCC Health Capital Consultants

Employee Benefits and Compensation

- Temporary elimination of the wage exclusion for reimbursements of qualified moving expenses and suspension of the moving expenses deduction (through 2025)
- Temporary elimination of the wage exclusion for reimbursements of the bicycling commuting deduction (through 2025)

MOCPA Missouri Society of Certified Public Accountants

New Code Sections 82, 132. Code Section 217 (moving deduction). "Tax reform imposes costs on tax-exempt healthcare organizations as for-profit peers weigh benefits" PricewaterhouseCoopers LLP, February 2018, https://www.pwc.com/us/en/health-industries/health-research-institute/publications/impact-of-TCJA.html (Accessed 7/31/18).

HCC Health Capital Consultants

Unrelated Business Taxable Income (UBTI)

- UBTI must be calculated separately for each unrelated business activity
- Any NOL from one of those activities cannot offset income from another
- How should one define a "*separate trade/business*"?
    - How does this intersect with the new 80% NOL limitation?
    - Should debt-financed income be considered as not derived from a "tr*ade/business*" and thus not subject to this separation, a/k/a silo-ing?
- 1.4% excise tax on net investment income of private colleges and universities with large endowments

MOCPA Missouri Society of Certified Public Accountants

"Seven key changes the new tax law will force hospitals to consider" By Harris Meyer, Modern Healthcare, http://www.modernhealthcare.com/article/20180102/NEWS/180109995 (Accessed 7/31/18). "Tax reform imposes costs on tax-exempt healthcare organizations as for-profit peers weigh benefits" PricewaterhouseCoopers LLP, February 2018, https://www.pwc.com/us/en/health-industries/health-research-institute/publications/impact-of-TCJA.html (Accessed 7/31/18).

HCC Health Capital Consultants

Unrelated Business Taxable Income (UBTI)

- <u>Example</u>: A 501(c)(3) has a $1 million gain from operating a commercial laboratory and a $1 million loss from a money-losing commercial joint venture
  - Old Rule: Gain/Loss would offset, and the 501(c)(3)'s net would be $0
  - New Rule: Gain and loss are calculated separately, and the 501(c)(3)'s net would be $1 million (on which it must pay taxes)

"Seven key changes the new tax law will force hospitals to consider" By Harris Meyer, Modern Healthcare, http://www.modernhealthcare.com/article/20180102/NEWS/180109995 (Accessed 7/31/18).
"Tax reform imposes costs on tax-exempt healthcare organizations as for-profit peers weigh benefits" PricewaterhouseCoopers LLP, February 2018, https://www.pwc.com/us/en/health-industries/health-research-institute/publications/impact-of-TCJA.html (Accessed 7/31/18).

Executive Compensation

- New 21% excise tax on compensation greater than $1 million for its 5 highest-paid employees
- Compensation for the direct provision of medical services and parachute payments **<u>do not apply</u>**
- Limits on deductibility of compensation expenses by certain taxpayers
  - For for-profit providers, the commission and performance-based compensation exceptions to the $1 million limit were repealed
  - Prior to the TCJA – The $1 million deduction limit was not applicable to certain performance-based compensation and commissions
  - Subsequent to the TCJA – Performance/commission compensation exceptions repealed

MOCPA Missouri Society of Certified Public Accountants

"Seven key changes the new tax law will force hospitals to consider" By Harris Meyer, Modern Healthcare, http://www.modernhealthcare.com/article/20180102/NEWS/180109995 (Accessed 7/31/18).

HCC Health Capital Consultants

Executive Compensation

"Applicable Employee" definition revised:

- *"The principal financial officer is now included as a covered employee;*
- *All individuals who hold the position of either principal executive officer or principal financial officer at any time during the taxable year are now covered employees;*
- *Covered employees include officers whose total compensation is required to be disclosed to shareholders by reason of them being amongst the three highest paid officers (other than the principal executive officer or principal financial officer). This is not an operational change but conforms the statute to IRS Notice 2007-49; and,*
- *For a "publicly held corporation" that is not required to file a proxy statement, covered employees are determined as if these rules applied"*

"US tax reform: Impact of Section 162(m) changes and transition relief on excessive compensation" Deloitte, https://www2.deloitte.com/content/dam/Deloitte/us/Documents/Tax/us-tax-reform-162m-updates.pdf (Accessed 9/6/18).

Executive Compensation

Potential Consequences:

- Non-profit hospitals consisting of multiple tax-exempt entities may revise their entity structure so that they only have to pay for 5 high-compensation employees in total (instead of 5 per organization)
- Can pay specialized physicians over $1 million and parachute payments for medical services without incurring the 21% excise tax

"Seven key changes the new tax law will force hospitals to consider" By Harris Meyer, Modern Healthcare, http://www.modernhealthcare.com/article/20180102/NEWS/180109995 (Accessed 7/31/18). "New Excise Tax Cuts Into Tax-Exempt Executive Compensation" By Scott C. Withrow, Esq., ABA Health eSource, Vol. 14, No. 7.

Executive Compensation

Potential Consequences (continued):

- For those physicians performing both non-clinical and clinical duties, hospitals may reallocate the clinical and non-clinical compensation of physician executives to avoid the $1 million threshold
- Tax-exempt entities will see increased costs while for-profits will see an increase in revenues, from tax dollars and repatriated funds

"Seven key changes the new tax law will force hospitals to consider" By Harris Meyer, Modern Healthcare, http://www.modernhealthcare.com/article/20180102/NEWS/180109995 (Accessed 7/31/18).

Individual Mandate Tax Penalty Repeal

- Reduces penalty for not having health insurance for at least 9 months of the year to $0 as of January 1, 2019
- Potential Consequences
  - Projected to significantly increase the number of uninsured, and consequently, uncompensated care
  - CBO and JCT estimated that the number of uninsured may increase by 4 million in 2019 and 13 million by 2027, and premiums would consequently rise 10% per year from 2018 to 2027

"Seven key changes the new tax law will force hospitals to consider" By Harris Meyer, Modern Healthcare, http://www.modernhealthcare.com/article/20180102/NEWS/180109995 (Accessed 7/31/18).

Tax Cuts & Jobs Act of 2017

Overall Potential Consequences:

- Borrowing rates on tax-exempt municipal bonds may rise (corporate tax cut may make tax-exempt interest less attractive)
- Corporate tax rate reduced (may affect publicly traded hospitals' 2017 reporting)

MOCPA Missouri Society of Certified Public Accountants

"Seven key changes the new tax law will force hospitals to consider" By Harris Meyer, Modern Healthcare, http://www.modernhealthcare.com/article/20180102/NEWS/180109995 (Accessed 7/31/18).

HCC Health Capital Consultants

Valuation Implications

Income Approach Implications:

- Overall, valuation methodology may swing more in favor of the Discounted Cash Flow (DCF) Method since history is under a different tax rule
- The discrete period to project cash flow needs to match the number of years that the new tax provisions are in effect (some are temporary)
- Projections of income tax expense and depreciation will be affected—also the benefits of NOLs
- Assumptions must be made as to how any cash savings will be used; not all of it will hit the bottom line immediately, depending on how it’s used: for reinvestment, share buybacks, debt repayments, dividends, new hires, etc.
- Depending on how companies use extra after-tax cash flow, assumptions about growth will be affected
- Some industries get special tax breaks under the TCJA

Valuation Implications

Market Approach Implications:

- The use of the market approach may give way more to the income approach since the tax changes affect future income (Remember: Value is the expectation of future benefit)
- Healthcare market multiples increased throughout 2017 and likely already reflect the anticipated tax changes

Asset/Cost Approach Implications:

- When applying an adjusted book value methodology, you will need to adjust the estimated taxes on the difference between the appraised value and tax basis of the assets

Cost of Capital Implications:

- A material change is not foreseen in the risk-free rate or equity risk premiums
- Tax shield benefits of interest expense will decrease, affecting the cost of debt (may affect optimal capital structure) and companies that rely on debt capital financing will likely see an increase to their WACC

Valuation Implications

Pass-Through Entity (PTE) Implications:

- The revised difference between the effective rate for C-Corps versus pass-through entities needs to be carefully considered. PTEs appear to increase in value under the TCJA, but appraisers must consider the intent of the owner as to what he or she will do with this increase in value

- Tax rates for individuals and small businesses have a termination date, so determining a terminal value may be more complicated

- As part of the PTE tax relief, the owner's reasonable compensation figures into the calculation of the new Qualified Business Income (QBI) deduction (Section 199A); this means more scrutiny on reasonable compensation and the need for more studies

Valuation Implications – Healthcare Specific

- The TCJA may have implications on a physician's bottom line, as well as his or her overall practice distributions
- The TCJA may have implications on a physician's practice setting – e.g., independence vs. employment
- High-income physicians will likely not benefit from the 20% deduction
- Lower-income physicians, who may benefit from the 20% deduction, should work to ensure they are capitalizing on this new provision of the TCJA, as this deduction expires December 31, 2025

Valuation Implications – Healthcare Specific

- The decrease in the corporate tax rate, excluding other provisions of the tax law, will clearly benefit for-profit hospitals and health systems, as well as pharmaceutical companies
- Starting in 2019, the TCJA repeals the ACA Individual Mandate that requires all Americans under 65 to have health insurance or pay an annual penalty
- Increase in the Medical Expense Deduction will benefit low and middle-income individuals facing high medical costs, especially senior citizens and people with chronic illnesses – will this result in increased utilization of healthcare services?

Questions?

If you have any questions regarding the content of this presentation, or on any other matter, please do not hesitate to contact me:

Todd Zigrang
Health Capital Consultants
2127 Innerbelt Business Center Drive, Suite 107
St. Louis, MO 63114
(314) 994-7641
tzigrang@healthcapital.com