

FMV Compliance with Equipment Lease Transactions

Earlier this year, the United States Attorney's Office Eastern District of Michigan issued a press release regarding a False Claims Act settlement involving a regional hospital system and physicians. Specifically, Covenant Healthcare System paid \$69.0 million to settle allegations in 2021 under the False Claims Act related to improper financial relationships with eight physicians and a physician-owned investment group. In addition to the False Claims Act, there were specific allegations pertaining to the Anti-Kickback Statute (AKS) and The Physician Self-Referral Law (Stark Law).

One component of the allegations included a medical equipment lease arrangement between Covenant and the physician-owned investment group. It was alleged that Covenant permitted the group to structure the equipment lease under non-arms-length negotiations with the purpose of inducing patient referrals.

Many health systems and physicians/physician groups pursue lease arrangements to provide flexibility in assessing long-term relationships and to reduce capital expenditure at the outset of an employment agreement. These agreements may include traditional personal property fixed asset leases, such as furniture, fixtures, and equipment, or material capital asset leases such as major movable medical equipment. With the increased popularity and projected growth of medical equipment lease agreements, there is the possibility of increased scrutiny and consideration of whether these agreements comply with federal laws.

Tips When Planning, Initiating, or Reviewing Medical Equipment Lease Agreements

Evaluating the Equipment Lease Structure

The structure of the equipment lease transaction has a significant impact on fair market value requirements, as well as other tax, accounting, and financial reporting requirements. When planning an equipment lease arrangement all parties involved should consider the following:

1. Is the leasing arrangement intended to be an operating lease or capital lease? Has future ownership of the subject equipment been discussed and established? For example, does the contract outline buy-out options or end-of-lease purchase options for the lessee at the current fair market value?
 - a. For operating leases, the determination of the lease term impacts anticipated residual value, interest rates, and fair market value lease payments. Does the lease term reasonably reflect a lease period that a third-party financial institution would consider?
 - b. What is a reasonable process to estimate the residual value and what support can be provided to reasonably estimate the future fair market value residual at lease termination? For example, does residual value simply reflect a percentage of equipment cost at lease inception, or does it reflect anticipated market depreciation of the subject equipment?
 - c. What processes or requirements would a financial institution include in developing the appropriate interest rate applicable to the transaction given the credit risk of the potential lessee (could be either a health system or a physician/physician group)? Are there expectations or objectives regarding required return on/of the investment?
2. Alternatively, is the leasing arrangement intended to be a capital lease? Do all parties understand that the title will transfer at lease termination?

Evaluating Internal Revenue Service and Tax Guidance

For federal income tax purposes, the Internal Revenue Service (IRS) has established guidelines for "true leases" or "fair market value lease." This guidance specifies that a true lease, or operating lease, involves a lease transaction where the lessor is deemed the owner of the asset and receives all depreciation and tax benefits. Guidelines to consider for true lease classification include:

1. Does the minimum investment reflect an amount equal to at least 20 percent of the cost of the subject equipment?
2. Does the minimum investment remain equal to at least 20 percent of the cost of the subject equipment?
3. Does the residual value at the end of the lease term reflect an amount equal to at least 20 percent of the original cost of the subject equipment?

If the above guidelines are not satisfied, a lease transaction would be considered a non-tax lease, or capital lease, where depreciation and tax benefits fall with the lessee.

Evaluating Financial Accounting Standards

Another consideration, for both a potential lessor and lessee, is to evaluate the accounting treatment and impact for a particular classification of the lease. For example, a potential lessee interested in reporting a capital lease for financial reporting purposes would need to confirm at least one of the following criteria:

1. Does the lease transfer ownership of the subject equipment to the lessee by the end of the lease term?
2. Does the lease grant the lessee a purchase option and is there reasonable certainty this option will be exercised?
3. Does the lease term cover a major part of the subject equipment's economic life?
4. Does the present value of the total lease payments equal or exceed FMV?

Alternatively, if the potential lessee cannot confirm any of the above criteria, they would classify the lease as an operating lease.

Evaluating the Stark and AKS Conditions and Standards

Once the appropriate equipment lease structure is determined the underlying details of the arrangement should be evaluated considering Stark and AKS, assuming the potential for financial and referral relationships between the parties.

Under Stark Law Section 42 CFR § 411.357(b) exceptions to the referral prohibition related to compensation arrangements subset (b) Rental of Equipment states that equipment lease arrangements do not constitute a financial relationship if the payments made by a lessee to a lessor meet the following requirements:

1. The lease arrangement is set out in writing, is signed by the parties, and specifies the equipment it covers.
2. The equipment leased does not exceed that which is reasonable and necessary for the legitimate business purposes of the lease arrangement and is used exclusively by the lessee when being used by the lessee (and is not shared with or used by the lessor or any person or entity related to the lessor).
 - a. For purposes of this paragraph (b), exclusive use means that the lessee (and any other lessees of the same equipment) uses the equipment to the exclusion of the lessor (or any person or entity related to the lessor). The lessor (or any person or entity related to the lessor) may not be an invitee of the lessee to use the equipment.
3. The duration of the lease arrangement is at least one year. If the lease arrangement is terminated with or without cause, the parties may not enter a new lease arrangement for the same equipment during the first year of the original lease arrangement to meet this requirement.
4. The rental charges over the term of the lease arrangement are set in advance, are consistent with fair market value, and are not determined:
 - a. In any manner that considers the volume or value of referrals or other business generated between the parties; or

- b. Using a formula based on:
 - i. A percentage of the revenue raised, earned, billed, collected, or otherwise attributable to the services performed on, or business generated, using the equipment; or
 - ii. Per-unit of service rental charges to the extent that such charges reflect services provided to patients referred by the lessor to the lessee.
5. The lease arrangement would be commercially reasonable even if no referrals were made between the parties.
6. If the lease arrangement expires after a term of at least one year, a holdover lease arrangement immediately following the expiration of the lease arrangement satisfies the requirements of this paragraph (b) if the following conditions are met:
 - a. The lease arrangement met the conditions of paragraphs (b)(1) through (5) of this section when the arrangement expired;
 - b. The holdover lease arrangement is on the same terms and conditions as the immediately preceding lease arrangement; and
 - c. The holdover lease arrangement continues to satisfy the conditions of paragraphs (b)(1) through (5) of this section.

Similarly, AKS Section 42 CFR § 1001.952(c) outlines safe harbor related to equipment rental by meeting the following six standards:

1. The lease agreement is set out in writing and signed by the parties.
2. The lease covers all equipment leased between the parties for the term of the lease and specifies the equipment covered by the lease.
3. If the lease is intended to provide the lessee with use of the equipment for periodic intervals of time, rather than on a full-time basis for the term of the lease, the lease specifies exactly the schedule of such intervals, their precise length, and the exact rent for such interval.
4. The term of the lease is for more than one year.
5. The aggregate rental charge is set in advance, is consistent with fair market value in arms-length transactions and is not determined in a manner that considers the volume or value of any referrals or business otherwise generated between the parties for which payment may be made in whole or in part under Medicare, Medicaid, or all other federal healthcare programs.
6. The aggregate equipment rental does not exceed what is reasonably necessary to accomplish the commercially reasonable business purpose of the rental.
 - a. Note: For purposes of paragraph (c) of this section, the term fair market value means the value of the equipment when obtained from a manufacturer or professional distributor, but shall not be adjusted to reflect the additional value on party (either the prospective lessee or lessor) would attribute to the equipment as a result of its proximity or convenience to sources of referrals or business otherwise generated for which payment may be made in whole or in part under Medicare, Medicaid, or other federal healthcare programs.

In summary, the absence of arms-length negotiations could imply equipment lease payments constructed above or below fair market value, and therefore, not meeting Stark exception requirements under Rental of Equipment that states, "The rental charges over the term of the agreement are consistent with fair market value."

Stark Law defines fair market value, with respect to the rental of equipment, as "the value in an arms-length transaction of rental property for general commercial purposes, consistent with general market value."

In addition, AKS prohibits soliciting or receiving remuneration "in return for purchasing, leasing, ordering, or arranging for or recommending purchasing, leasing, or ordering any good, facility, service, or item for which payment may be made in whole or in part under a federal healthcare program."

Based on these AKS and Stark Law conditions, equipment lease arrangements should mirror the terms of disinterested third parties, such as banks, equipment leasing companies, and other financial institutions that provide asset-based financial services. These examples of disinterested third parties represent individuals and/or groups that act independently, are unrelated and unaffiliated, and act within arms-length capacities.

If you are contemplating, reviewing, or renewing a capital asset equipment lease agreement and require expertise, please contact VMG Health. The VMG Health [Capital Asset Valuation](#) team has performed hundreds of medical equipment, personal property, and related capital asset lease transaction appraisals to assist with arrangements for physician practices, hospitals, imaging centers, ambulatory surgery centers, radiation therapy, medical transportation, and many others.

Sources

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- 4 [Technavio. \(2022\). Healthcare Equipment Leasing Market by Product, End-user, and Geography - Forecast and Analysis 2023-2027.](#)
- 5 [Global Market Insights. \(2022\). Medical Equipment Financing Market - By Equipment \(Diagnostics Equipment, Therapeutic Equipment, Patient Monitoring Equipment, Laboratory Equipment, Medical Furniture\), By Type, By End-use & Forecast, 2022-2030.](#)
- 6 Internal Revenue Service Revenue Procedures 2001-28
- 7 Accounting Standards Codification Topic 842
- 8 42 CFR § 411.351 Definitions
- 9 42 U.S. Code § 1320a-7b

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