

**EXECUTIVE SUMMARY****BUSINESS LAW AND GOVERNANCE  
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**Healthcare Equipment Leasing and Purchasing**

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The year 2010 may turn out to be momentous for equipment leasing. For starters, 2010 is the last year for a significant tax deduction allowing for the expensing of equipment purchases. Second, 2010 may be the year that operating leases and capital leases come to be treated the same for accounting purposes, even if only for purposes of financial planning. This potential change in accounting treatment has profound implications for healthcare providers that are trying to satisfy the financial covenants in their bonds and other financial documents.

The first of these two changes will primarily affect for-profit healthcare providers. The second change would affect nonprofit and for-profit healthcare providers alike. Both changes taken together mean that decisions of whether or not to lease equipment and how to structure such leases are likely to be considerably different in 2011 than they are at this point of 2010.

**Tax Incentive to Purchase**

For the rest of 2010, private physician practices and other for-profit healthcare providers have an added incentive to buy equipment (hardware and software) rather than get it through a traditional operating lease.<sup>1</sup> Internal Revenue Code Section 179(a) of 1986, as amended, permits, within limits, property used in an active trade or business to be fully expensed (rather than depreciated) in the year

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<sup>1</sup> An expanded discussion of this issue is available in David A. Lips, *Depreciating v. Expensing in 2010*, AHLA Business Law Update, May 11, 2010.

when it is placed in service.<sup>2</sup> Through the remainder of 2010, a business may buy qualified property<sup>3</sup> and expense it up to \$250,000. The Section 179 deduction applies up to \$800,000 in equipment purchases. After this year, the respective limitations revert to \$25,000 and \$200,000. In order to qualify for the expanded Section 179 treatment, the property must be placed in service by the end of 2010. The amount expensed may generally not exceed the business' annual taxable income.<sup>4</sup>

While Section 179 property is defined as having been “acquired by purchase for use in the active conduct of a trade or business,”<sup>5</sup> “purchase” is defined loosely to mean “any acquisition of property.”<sup>6</sup> As will be discussed later, Section 179 may apply to capital leases as well as to true purchases because in both cases, the property is accounted for as becoming the property of the acquiring party rather than as property that continues to be owned by the person who parted with it. (Such is not the case with an operating lease.) Even if the “purchaser” enters into a capital lease and has no payments during the first year under the terms of the agreement, the capital lessee may deduct the purchase price from current gross income under the parameters of Section 179.<sup>7</sup> Needless to say, this is an enormous advantage to a small business or to a tax-exempt organization that uses Section 179 property to generate unrelated, business-taxable income.

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<sup>2</sup> See *Michael v. Comm’r*, T.C. Memo 2010-75 (Apr. 14, 2010), at 17-19 (disallowing Section 179(a) deduction to a dental practice because the taxpayer was unable to establish when the equipment (a vehicle) had been placed in service), available at [www.ustaxcourt.gov/InOpHistoric/willockc.tcm.wpd.pdf](http://www.ustaxcourt.gov/InOpHistoric/willockc.tcm.wpd.pdf).

<sup>3</sup> Eligible property includes machinery, equipment, off-the-shelf computer software, and equipment that is attached to a building (e.g., testing equipment and refrigerators). See Internal Revenue Service, *How to Depreciate Property*, Pub. 946 (2009), at 15. Real property is not eligible.

<sup>4</sup> I.R.C. § 179(b)(3)(A) (2006). Carryover provisions may, however, apply. (I.R.C. § 179(b)(3)(B) (2006).) The dollar limitations in Section 179 apply to all members of a controlled group as though it were a single entity. (I.R.C. § 179(d)(6)(A) (2006).)

<sup>5</sup> I.R.C. § 179(d)(1)(C) (2006).

<sup>6</sup> I.R.C. § 179(d)(2) (2006).

<sup>7</sup> For more information, see [section179.org](http://section179.org) (explaining Section 179 in detail and, in the present context, its application to capital leases).

## Other Purchasing Considerations

Healthcare providers as a rule have significant needs for equipment and limited resources with which to buy it. If they have funds available, they may buy the equipment outright. Or they may get a loan to fund an equipment purchase. The present economy may make either course more attractive than it normally is.

“Now is a great time to invest in business equipment, because there are opportunities to negotiate better prices following any economic slowdown. Interest rates today are near historic lows, so it’s more affordable to borrow money today than it has been for years.”<sup>8</sup>

Loans to buy equipment are usually secured either through banks or through equipment finance companies. Bank term loans often last for the expected useful life of the equipment, with five years being typical. They are generally secured on the health provider’s other assets up to the value of the equipment that is being bought or sometimes through accounts receivable. In contrast, an equipment finance agreement with an equipment finance company places a security interest only on the equipment that is being financed.

Bank loans may often be prepaid without penalty, although the downside is that, unlike equipment finance companies, banks often require the maintenance of financial ratios. It may be possible to structure a bank loan so that payments are required only after a few months and gradually grow in amount, although a down payment on principal may be necessary. The amount of the loan may drive the terms. A service manager for the Florida Practice Solutions arm of Bank of America explained: “We will lend up to \$200,000 without financials. If a transaction is for less than \$75,000, no collateral is required. Loans up to \$100,000 are approved in about a day.”<sup>9</sup> Lines of credit may be especially attractive.

At Washington Trust Company, a regional bank serving Rhode Island, Connecticut and Massachusetts, physicians can get an interest-only loan

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<sup>8</sup> Steven Prime, *Equipping Your Practice for Success*, DENTAL PRAC. MGMT, Winter 2009.

<sup>9</sup> Irene Lombardo, *Electronic Health Record System: You May Need to Weigh Your Financing Options Soon*, YOUR HEALTHY PRAC., Spring 2010.

up to \$200,000 on their line of credit at prime +0 percent for the first year and prime +1 percent during the second year.

‘The interest-only period gives them time to get the system in place,’ says Washington Trust vice president and market manager Lori Dufficy. ‘They can then convert it to a fixed-rate term loan, amortizing the cost over seven years.’<sup>10</sup>

If the healthcare provider is for profit, a relevant consideration is whether the sales tax associated with buying the equipment is offset by the depreciation expense. The amount of the expenditure will determine whether these factors are significant enough to enter into the calculation.

If the provider is a nonprofit, a purely economic decision would compare the present values of payments under a lease against those under a loan. For the reasons below, however, in the healthcare arena a host of factors often make leasing more attractive than buying, even in the unusual case when leasing is more expensive than financing the purchase through a loan.

## **Leasing**

Healthcare providers often find it more economical to lease equipment rather than buy it. A lease is usually cheaper than a conventional loan is, and some leases offer a more flexible payment schedule than is permitted in typical bank financing. For example, leases today often give the lessee the option to purchase the equipment within the first half year and terminate the lease, although this option often requires an additional fee to exercise it. In addition, banks and other traditional lending institutions usually report loans to credit bureaus, but equipment financing companies generally do not. This factor is relevant to providers that are concerned with maintaining a favorable debt service coverage ratio.

Leasing equipment rather than buying it serves several other purposes. First, a lease involves small up-front costs or even no up-front costs, allowing the healthcare provider’s cash to be used for other business needs (for instance,

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<sup>10</sup> *Id.*

inventory). For example, EZ Medical Lease (a subsidiary of Washington Trust) will cover the entire purchase price of the equipment and, through Washington Trust's business partner Synergy Inc., will also cover software costs. By preserving working capital, a lease enables the healthcare provider to leave credit lines unobstructed for immediate cash requirements and short-term purchases.

Second, because healthcare is in the forefront of cutting-edge product development, equipment becomes obsolete quickly. Leasing, instead of owning, equipment permits the healthcare provider to replace equipment in line with changes in technology. Concern with using outdated equipment is especially prevalent in specialized medical practices. Leasing allows for perpetual equipment upgrades and shifts the risk of obsolescence to the lessor.

A third factor in favor of leasing is that the provider may try out new forms of equipment and processes without committing to them.

Fourth, capital budgeting is subject to closer scrutiny and a longer approval process than leasing is. If the board must weigh in on capital purchases, the hospital chief executive officer can avoid bureaucratic delays by getting the equipment through a lease.

About 80% of all companies in the United States—in and out of healthcare—get some of their equipment through leases. In the U.S., equipment leasing is a \$650 billion per-year industry. Equipment leasing companies in the healthcare industry—for example, General Electric, Siemens, and Cardinal Health—work in tandem with distributors, manufacturers, and medical sales professionals to offer payment options to physicians and hospitals. Some payment plans are interest free for a certain time period.

### **Operating Leases Versus Capital Leases**

Equipment leases are generally of two kinds: an operating lease and a capital lease. An operating lease is a short-term rental that allows the lessee to use the equipment for a set amount of time. Operating leases let the lessee replace the

equipment at the end of the lease and usually permit cancellation during the lease term. Equipment typically subject to operating leases includes vehicles, computers, and copier machines. The lessor (that is the owner, the company leasing the equipment) is responsible for paying insurance and taxes on the equipment, but these tend to be recaptured through the lease payments. Frequently the lessee enters into a preventative maintenance program with the lessor as part of the lease contract and, because the lessor owns the equipment, the lessor has a greater incentive to maintain the equipment well. The lease generally involves delivery and installation of the equipment, training, and tech support. Operating lease agreements may also include upgrades. Software and hardware are typically packaged in operating leases involving intellectual technology.

In contrast, a capital lease (also known as a finance lease or a financial lease) is akin to an asset purchase, which allows the equipment to be thought of as capital. Capital leases last for virtually an asset's entire economic life and enable the lessee to end up owning the equipment.<sup>11</sup> The lease agreement is usually non-cancellable, or cancellable with a stiff penalty fee. Capital leases are commonly entered into with the expectation that the equipment will have high residual value after the term of the lease. Capital leases usually give the lessee the option to purchase the equipment for a nominal amount at the end of the lease. Dollar-out leases provide that the equipment may be bought for \$1. With capital leases, the lessee—in our case, the healthcare provider—pays directly for maintenance, insurance, and taxes associated with owning and using the equipment.

While this discussion focuses on equipment leases, real property leases are also categorized as operating and capital and are subject to a similar analysis.

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<sup>11</sup> If the lease lasts for at least 75% of an asset's useful life, it is considered a capital lease. A lease is also considered a capital lease if the present value of all lease payments is at least 90% of the asset's fair market value. Fin. Acct. Standards Bd., Accounting for Leases, Statement of Financial Accounting Standards No. 13 (1976), at Section 7.

Capital leases in healthcare often involve sale/leasebacks. In such an arrangement, the healthcare provider (for example, a hospital) that owns an asset (for instance, a clinic) sells it and then leases it back. Sale/leasebacks allow the healthcare provider to use the asset while generating capital from the sale.

For a given term, an operating lease generally involves a lower fixed payment than a capital lease does because it does not allow for the buildup of equity in the equipment. Operating lease payments are generally constant during the term of the lease, whereas payments under capital leases are greater in the early years than in the later years of the term.

### **Accounting Changes on the Horizon**

Both operating and capital leases involve an obligation to pay, but they have been treated disparately in the accounting world. One virtue of an operating lease has been that it is kept off the balance sheet. Instead, the lease payment is expensed on the income statement (or, in the nonprofit world, the statement of operations) (often as Rent Expense or something similar) and deducted as overhead from the net income that is subject to tax. Capital leases, on the other hand, have been reported as both fixed assets (Leased Asset) and liabilities (Lease Payable). The asset amount—which equals the total lease payments' present value up to the fair market value of the equipment—is depreciated over time. Part of the lease payments is considered to be interest and may be deducted as such from income taxes. (The interest amount depends on the amortization/depreciation schedule that the lessor provides.) Capital leases are sometimes called “non-tax leases” because the total lease payments over the course of the lease are depreciated or amortized rather than deducted from operating expenses, as the payments under operating leases are.

Because of this different accounting treatment, capital leases show up on the balance sheet but operating leases do not. Since operating leases are not

recorded in this way, arguably assets and liabilities of companies and institutions with operating leases have been under reported.<sup>12</sup>

In March 2009, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board issued a discussion paper on this subject that recommended treating the two kinds of leases alike. The press release announcing the paper's release identified the main issues:

The different accounting treatment of finance and operating leases has given rise to various problems, in particular:

- Many users of financial statements believe that all lease contracts give rise to assets and liabilities that should be recognized in the financial statements of lessees. Therefore these users routinely adjust the recognized amounts in the statement of financial position in an attempt to assess the effect of the assets and liabilities resulting from operating lease contracts.
- The split between finance leases and operating leases can result in similar transactions being accounted for very differently, reducing comparability for users of financial statements.
- The difference in the accounting treatment of finance leases and operating leases also provides opportunities to structure transactions so as to achieve a particular lease classification.

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Robert Herz, chairman of FASB, said:

The proposals contained in this discussion paper are intended to improve the transparency, credibility and usefulness of lease accounting.<sup>13</sup>

Review and comment were sought after the paper's release. FASB is expected to issue either a modified proposal or a final draft in Summer 2010. Under the new rule, both operating leases and capital leases would be treated as liabilities on the balance sheet. Rob McCoy, a partner at Denver's BKD LLP, explains:

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<sup>12</sup> Just as liabilities are under reported, net asset values may be considered to be under reported, which would lead to a distortion in calculating return on assets.

<sup>13</sup> Press Release, Int'l Acct. Standards Bd., IASB and FASB Launch Public Consultation on a Future Standard on Lease Accounting (Mar. 19, 2009). For the paper, see Int'l Acct. Standards Bd., *Leases: Preliminary Views* (Mar. 2009), available at [www.iasb.org/NR/rdonlyres/FF3A33DB-E40D-4125-9ABD-9AF51EB92627/0/DPLLeasesPreliminaryViews.pdf](http://www.iasb.org/NR/rdonlyres/FF3A33DB-E40D-4125-9ABD-9AF51EB92627/0/DPLLeasesPreliminaryViews.pdf).

“With a capital lease, the asset and the obligation go on your balance sheet. If it’s an operating lease, you just disclose it in your footnotes. What they’re proposing to go to is that all leases will result in an obligation on the balance sheet.”<sup>14</sup> This change will nullify the lessee accounting framework developed in Statement of Financial Accounting Standards No. 13, Accounting for Leases, which treats capital and operating leases differently for purposes of the lessee.<sup>15</sup>

These changes will result in an increase in reported debt. Even though the new rule would not go into effect for about two years, attorneys should advise their clients now about the ramifications that this change may have. For example, loan agreements between financial institutions and businesses often contain debt covenants (e.g., maintenance of a specified debt service coverage ratio). Bond documents routinely have financial covenants that revolve around the borrower’s overall level of debt. Under the new rules, a borrower would potentially be in greater risk of default if debt is defined to include operating leases, especially for high-value items (e.g., real estate or highly sophisticated medical equipment). Given the present uncertainty, it may make sense to add a provision to such documents defining debt in a way that “excludes any effect from future accounting changes.”<sup>16</sup>

### **Acquiring an Electronic Health Record System**

The 2009 American Recovery and Reinvestment Act provides financial incentives for healthcare providers to use electronic health record (EHR) systems. In 2011, federal subsidies will be available for acquiring EHR systems.

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<sup>14</sup> Renee McGraw, *Lease-Accounting Changes Will Alter Company Books*, Denver Bus. J., Mar. 12, 2010, available at <http://denver.bizjournals.com/denver/stories/2010/03/15/story6.html>. This change will affect far more than loan agreements. “EBITDA [earnings before interest, taxes, depreciation, and amortization] of the lessee would likely increase as a result of the proposed lease accounting change since rent expense will be replaced with interest and depreciation expense, both of which are not included in EBITDA. . . . This increase in EBITDA could increase bonuses, commission compensation, or earnout payments that are linked to EBITDA even though the company’s cash position has not changed and the company has not received any additional value for the increase in EBITDA.” Timothy H. Shea, *Looming Lease Accounting Rule Changes: Impact on Earnings, Debt Covenants, Compensation Arrangements, and Earnout Agreements*, Apr. 30, 2009, available at [www.foley.com/publications/pub\\_detail.aspx?pubid=5989](http://www.foley.com/publications/pub_detail.aspx?pubid=5989).

<sup>15</sup> The proposed changes do not reach accounting treatment by lessors.

<sup>16</sup> McGraw, *supra* note 14 (paraphrasing MaCoy).

By 2015, providers will be penalized for not using EHRs. So now is an ideal time for providers to consider making an investment in this technology.<sup>17</sup>

Again, providers need to consider whether to buy or lease EHR systems.<sup>18</sup> Smaller physician practices may decide to use another entity's EHR. Software-as-a-Service provides subscriptions for using EHR applications through the Internet. The monthly fee pays for upgrades and data backup, although implementation, setup, and training are priced separately.

Some health plans, hospitals, and health systems provide EHR subsidies to affiliated physician practices. The subsidies are for software only and are limited to 85% of the purchase price. By law, physicians must pay the remaining 15% as well as the price of the hardware and any additional costs (e.g., monthly service fees). Such arrangements are fraught with legal implications and should be handled carefully.<sup>19</sup>

### **Future Prospects**

The healthcare industry has been beset by enormous financial challenges since the beginning of the credit crisis.<sup>20</sup> Capital spending has declined significantly. This situation has increased the attractiveness of leasing equipment.

For-profit healthcare companies and providers may still wish to take advantage of Internal Revenue Code Section 179(a) with its broad allowance for expensing equipment purchases and capital leases. Nonprofit providers will be faced with the traditional choice between leasing and buying equipment and the further choice, if leasing is preferred, between capital and operating leases, with the

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<sup>17</sup> The American Medical Association maintains a helpful Internet site pertaining to health information technology, including EHRs. See [www.ama-assn.org/ama/pub/physician-resources/solutions-managing-your-practice/health-information-technology/hit-resources-activities.shtml](http://www.ama-assn.org/ama/pub/physician-resources/solutions-managing-your-practice/health-information-technology/hit-resources-activities.shtml).

<sup>18</sup> Providers considering such a purchase may find particularly helpful Joe Swab and Vince Ciotti, *What to Consider When Purchasing an EHR System*, HEALTHCARE FIN. MGT., May 2010, at 38 - 41.

<sup>19</sup> For a good resource, see Michael H. Zaroukian, Am. Med. Ass'n, *Health Information Technology Donations: A Guide for Physicians*, available at [www.ama-assn.org/ama1/pub/upload/mm/472/hitdonate\\_physicians.pdf](http://www.ama-assn.org/ama1/pub/upload/mm/472/hitdonate_physicians.pdf).

<sup>20</sup> These are described in detail in Part II of David A. Lips, *Healthcare Capital Finance: In Good and Challenging Times* (AHLA 2009).

expectation that the accounting differences between these two kinds of leases may cease in the near future.

Both for-profit and nonprofit providers are strongly encouraged to assess the impact of treating operating leases under the accounting rules now applicable to capital leases. The implications for compliance with debt covenants in bond and loan documents may require careful analysis and planning.

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