Understanding and evaluating deal considerations in the home health care sector

An update for private equity investors

Investments in health care providers and companies that provide services to health care providers require careful consideration. This issue explores certain strategic, financial, and tax issues that private equity investors should take into account when evaluating investments.

Financial and operational considerations

Medicare reimbursement complexities— Many home health businesses derive 100% of their revenue from Medicare and therefore they are highly sensitive to changes in Medicare reimbursement. Though non-Medicare reimbursement is often fee-for-service, Medicare reimbursement can be more complex, with ultimate reimbursement amounts difficult to initially estimate. At the onset of the episode and based on a physician's plan of care, home health agencies bill Medicare a Request for Anticipated Payment (RAP) that estimates the total amount of reimbursement it is owed for that one episode. Based on this initial RAP, Medicare pays approximately half of the total episode up front. The remaining balance is paid upon submission of the final claim, once the episode has concluded. Final claims are often different from the initial RAP and any difference will be trued-up by Medicare in its end of episode payment. The differences can arise for several reasons, including the following:

- **LUPA** — If the beneficiary requires four or fewer visits (referred to as low-utilization payment adjustment or LUPA)
- **Outlier** — If the home health care practice incurs unusually high costs
- **PEP** — If the beneficiary is discharged or readmitted during the episode (referred to as a partial episode payment adjustment or PEP)

Home health agencies typically defer recognition of the upfront episodic payment and recognize into revenue the total estimated episodic reimbursement ratably over the 60-day period. Investors should understand how home health agencies recognize revenue and account for any differences between initial RAP and final claim to determine the impact, if any, on quality of earnings. Investors should also consider the cash flow and tax implications to the home health care practice that result from Medicare's episodic payment cadence. Further note that there are current proposals to reduce home health reimbursement rates.

New value-based payment and care models — In the health care industry's quest for lower costs and higher quality, regulators, providers, and payers are piloting new value- and outcomes-based payment and care delivery models including Accountable Care Organizations, payment bundling and patient centered medical homes. Investors should assess how much revenue a home health care practice derives from these non-traditional sources, including how the revenue is earned and if there are any clawback or repayment features.

Professional liability insurance — Home health agencies are often insured for professional liability risk (medical malpractice risk) on a "claims-made" basis. While this coverage provides for lower annual cash premiums, it provides coverage for only the claims-made or reported during the current accident year. Home health agencies that are insured under claims-made policies should also account for the exposure related to incurred, but not reported (IBNR) claims. Investors should consider the impact of the changes in the estimated IBNR claim liability on the historical quality of earnings, as such estimates are often determined based on a complex actuarial analysis which utilizes sensitive assumptions. Buyers often require the selling shareholders to acquire, at the selling shareholders' expense, a "tail-policy" to mitigate the historical insurance exposure.

Billing & Coding — Improper billing of Medicare and Medicaid can result in significant fines and penalties. Additionally, if proper billing and coding requirements are not followed, revenue may be misstated, which also impact can run rate revenue and quality of earnings. Performing a billing and coding assessment is often a critical step during diligence. This typically includes selecting a sample of patient records and their related billing documents to assess whether the company has documented evidence of services being performed and has billed correctly for those services.

Further, full payment for Medicare services requires the timely submission of a final claim after the episode of care, which itself requires information from the physician. Failure to obtain the necessary physician information and/or submit a final claim in a timely manner will result in a recoupment of the upfront payment and could have a negative impact on the cash flows of the home health agency.

De novo / retail analysis — Home health agencies are often comprised of several locations with centralized back office support. However, payor mix and staffing levels may differ at each location. Investors should consider performing a same-store analysis to identify outperforming or underperforming locations with the awareness that certain expenses may be allocated differently to each location. Additionally, a de novo analysis can help determine time to profitability for each location and inform investor models as to start-up loss expectations. Investors should analyze organic and acquired growth trends to help support future projections.

Tax considerations

Tax reform — The potential reform of the US tax code has been widely discussed in recent months. Based on high-level proposals and outlines put forward by President Trump and congressional Republicans, potential provisions that could impact home health care practices include, but are not limited to: (i) disallowed current deductions for net interest expense paired with accelerated tax depreciation (for qualifying expenditures), (ii) reduced tax rates on corporate and pass-through income, and (iii) reduced tax rates on capital gain and dividend income. The US tax reform discussion remains in its early stages and critical decisions are yet to be made (e.g., should the proposed rate reductions be fully offset by other changes to the tax base that raise revenue). Investors in home health care practices should closely monitor developments in this area to evaluate the potential impact to the tax profile of the acquired business.

Independent contractors — Home health care practices may treat certain professionals as independent contractors. The proper classification of an individual as an independent contractor vs. an employee is highly dependent on the facts and circumstances. Home health care practices that misclassify certain individuals as independent contractors may be subject to income tax withholding exposure and payroll tax exposure, which could be sizable depending on the number of independent contractors and the lengthy statutes of limitations. Underpayment of payroll taxes could also impact a home health care practice's quality of earnings.

Contractual allowances / tax accounting methods — Home health care practices may accrue an expense in their financial statements for the expected difference between the amount charged for a service compared to the amount expected to be reimbursed from third-party payors (e.g., insurance companies or government payors) – often referred to as a "contractual allowance." For financial statement purposes, the contractual allowance is an expense reflected in pre-tax book income. From a tax perspective, home health care practices should analyze the contractual allowance expense and evaluate if the expense should be deducted in the current period or deferred until a future period. Taxable income generally reflects contractual reimbursement rates based on the time of services and billings. If the contractual allowance expense is an estimate, the expense may not be currently deductible for tax purposes. If the pre-tax accounting expense is deferred for tax purposes, the home health care practices will have a temporary difference and companies should consider the accounting for income tax implications in their financial statements. The IRS has allowed qualifying taxpayers to apply a safe harbor for contractual allowance; however, an analysis should be completed to confirm whether the safe harbor may be applied. If the home health care practice has not historically evaluated contractual allowance adjustments for tax purposes, further analysis should be considered to evaluate if the taxpayer qualifies for the safe harbor and the magnitude of potential adjustments to the historically filed US income tax returns.

Life Sciences & Health Care M&A Transaction Services team

Phil Pfrang
National Managing Partner
LSHC M&A Transaction Services
Deloitte & Touche LLP
New York office
+1 212 436 3481
ppfrang@deloitte.com

Kyle Woitel
National Tax Leader
LSHC M&A Transaction Services
Deloitte Tax LLP
Chicago office
+1 312 486 3499
kwoitel@deloitte.com

Todd Pierro
Partner
LSHC M&A Transaction Services
Deloitte & Touche LLP
Parsippany office
+1 973 602 5560
tpierro@deloitte.com

Ben Clark
Partner
LSHC M&A Transaction Services
Deloitte & Touche LLP
Los Angeles office
+1 213 688 4166
beclark@deloitte.com

Bryan Martin
Partner
LSHC M&A Transaction Services
Deloitte & Touche LLP
Boston office
+1 617 437 2834
bryanmartin@deloitte.com

Kevin Six
Partner
LSHC M&A Transaction Services
Deloitte Tax LLP
Dallas office
+1 214 840 7553
ksix@deloitte.com

Chris Caruso
Partner
LSHC M&A Transaction Services
Deloitte & Touche LLP
Chicago office
+1 312 486 3554
ccaruso@deloitte.com

James Gorayeb
Partner
LSHC M&A Transaction Services
Deloitte & Touche LLP
New York office
+1 212 436 3755
jgorayeb@deloitte.com

Scott Venus
Managing Director
LSHC M&A Transaction Services
Deloitte & Touche LLP
Charlotte office
+1 704 887 1807
svenus@deloitte.com

If you would like to be added to this distribution or would like to receive previous issues of our series on health care sector deal risks, please contact usmaservices@deloitte.com.

Access previous issues in this series at www.deloitte.com/us/lshcbriefs.