Separate But Related – Hospitals Within Hospitals and the 15 Percent Inpatient Operating Costs Limitation

by

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Introduction

The hospital-within-a-hospital ("HwH")venue, whereby a separate provider licensed and certified as a hospital in its own right is "co-located" with another, hospital has proven efficient and popular for rehabilitation hospitals and especially long term acute care hospitals ("LTACHs"). "Co-location" refers to the fact that the smaller specialty hospital, such as the rehab hospital or LTACH, is occupying a portion of the larger, acute care "host" hospital's space, usually through a lease arrangement. CMS has developed a number of rules to ensure that the HwH is a bona fide *separate* entity from the host hospital and is not actually a disguised unit of that hospital. The separateness rule that probably has caused the most confusion for HwH owners is the requirement that no more than 15 percent of the HwH's inpatient operating costs may be purchased from the host hospital.

The Separate Control Requirement

CMS has long recognized the difference between ownership and control. In CMS's view, separateness is established by control. If the host hospital is not in a position to directly or indirectly control the HwH, than the two hospitals are considered separate. The requirements that CMS has established to ensure separate control of the HwH and host hospital include a requirement that key personnel be separate from those of the host hospital, including:

- **Separate governing body**. The HwH must have a governing body that is not under the control of the host hospital or a third party that controls both the host hospital and the HwH;
- **Separate chief medical officer**. The HwH must have a chief medical officer who is not employed by or under contract with either the host hospital or a third party that controls both hospitals.
- **Separate medical staff**. The HwH governing body must adopt and enforce medical staff bylaws that are separate from those of the host hospital, and which include a process for the HwH to credential its own medical staff separately from the host hospital's credentialing process.
- **Chief executive officer**. The HwH must have its own chief executive officer who is not employed by, or under contract with, either the host hospital or a third party that controls both hospitals.[1]

[1] 42 C.F.R. § 412.22(e).

"Basic" Functions Defined

CMS's regulations further ensure that the HwH is a separate entity from the host hospital by requiring that the HwH either perform "basic" hospital functions itself or through a contract with third parties. These basic functions include quality assurance, medical staff services, nursing services, medical record services, pharmaceutical services, radiologic services, laboratory services, utilization review, and infection control.[2] In the first set of rules governing HwHs that CMS issued in 1994,[3] CMS required that all basic services "except for food and dietetic services and housekeeping, maintenance, and other services necessary to maintain a clean and safe physical environment" must either be provided directly by the HwH or under contract with an entity other than the host hospital.

A difficulty that many providers had with this rule is that some of these "basic" functions could be furnished more cost-effectively for the HwH and more conveniently for patients if they were performed under a contract with the host hospital. For example, it would not be cost effective for a relatively small HwH to maintain its own fully-equipped laboratory and its own radiological equipment, and it would not be convenient for the HwH's patients if they had to be transported via ambulance to another location for every CT scan or MRI that they required. Thus, the providers argued, the HwH should be able to contract with the host hospital for such services as stat lab tests and radiological procedures. As a result of these concerns, the basis function rule now is usually applied only to LTACHs on the campus of a health system.

The 15 Percent Rule

CMS agreed and soon issued new rules[4] that retained the original basic services rule as an option,[5] but added two new options by which the HwH could satisfy the basic services rule. Under one of the new options, the basic services rule would not apply at all if at least 75 percent of the HwH's patients were referred to it from sources other than the host hospital.[6] Under the other option, the hospital is free to contract with the host hospital for basic services, *provided* that the cost of the services contracted for with the host hospital "is no more than 15 percent of the hospital's total inpatient operating costs" (excluding the lease payment).[7] CMS chose the 15 percent threshold for this option because its data showed that dietetic, housekeeping and maintenance expenses incurred by HwHs typically ranged from 5 to 17 percent of all inpatient operating costs.[8]

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[2] 42 C.F.R. § 412.22(e)(5).
[3] 59 Fed. Reg. 45389 (Sept. 1, 1994).
[4] 60 Fed. Reg. 29202 (June 2, 1995).
[5] 42 C.F.R. § 412.22(e)(5)(i).
[6] 42 C.F.R. § 412.22(e)(5)(iii).
[7] 42 C.F.R. § 412.22(e)(5)(ii).
[8] 60 Fed. Reg. 29244 (June 2, 1995).

Because of the considerations of cost-effectiveness and patient convenience previously discussed, the original basic services option is not commonly employed by HwHs. Similarly, because most HwHs receive the bulk of their referrals from the host hospital, the 75 percent referral option is infrequently employed. Thus, most HwHs choose to comply with what has come to be known as "the 15 percent rule." For these hospitals the crucial questions then become what "inpatient operating costs" must be allocated toward the 15 percent threshold and what items and services can be purchased from the host hospital without implicating the 15 percent rule. Answers to these questions can be found first in the regulations themselves and then in more detail in CMS' Provider Reimbursement Manual.

According the regulation, inpatient operating costs include:

- Operating costs for routine services, such as room, board, and routine nursing services;
- Operating costs for ancillary services, such as radiology and laboratory services furnished to hospital inpatients; and
- Malpractice insurance costs related to services furnished to inpatients.[9]

The regulation also states that inpatient operating costs include preadmission services that are diagnostic (including clinical diagnostic laboratory tests) and preadmission services that "are furnished in connection with the principal diagnosis that requires the beneficiary to be admitted as an inpatient" but does not include preadmission ambulance services and preadmission maintenance renal dialysis.[10]

In its Provider Reimbursement Manual,[11] CMS provides a list of costs that are excluded from a hospital's capital-related costs. As the Manual notes, "to the extent that these costs are allowable, they may be included in determining each provider's operating costs." Thus, if a cost is included on the following list, it must be allocated toward the 15 percent rule in evaluating any contracts for services that the HwH has with the host hospital:

- "Repair or maintenance of equipment or facilities." Thus, any repair or maintenance agreements with the host hospital would count toward the 15 percent rule. According to the Manual, maintenance agreements constitute operating costs, "even where those agreements provide for the replacement of assets in certain circumstances;"

- "Amounts included in rentals or lease payments for repair or maintenance agreements." Therefore, including the repair or

[9] 42 C.F.R. § 412.2(c).
[10] 42 C.F.R. § 412.40(c)(2).
[11] Provider Reimbursement Manual § 2806.2 Costs Excluded From Capital-Related Costs (CMS-Pub. 15-1).

maintenance agreement cost as part of the lease payment does not remove it from the 15 percent rule;

- "Interest expense incurred to borrow working capital (for operating expenses);"
- "General liability insurance or any other form of insurance to provide protection other than for the replacement of depreciable assets or to pay capital-related costs in the case of business interruption." Thus a real property insurance policy procured from the host hospital would not be considered an operating expense, but general liability and malpractice insurance would count toward the 15 percent rule;
- "Taxes other than those assessed on the basis of some valuation of land or depreciable assets used for patient care (taxes not related to patient care, such as income taxes, are not allowable and are, therefore, not included among either capital-related or operating costs);"
- "The costs of minor equipment that are charged off to expense;"
- "Cleaning services, guard services, and utilities." Note that these are the type of services specifically contemplated by CMS in arriving at the 15 percent threshold; and
- "Abandoned planning costs. Allowable abandoned planning costs are administrative and general costs and are included in allowable costs either in the year of abandonment or amortized over a 3-year period.

Conclusion

The effect of the 15 percent rule is that most HwHs will be able to contract with the host hospital for dietetic, housekeeping, and maintenance services. They will also be able to contract with the host hospital for such services as stat lab tests, CT scans and MRIs. Other basic services, such as pharmacy,[12] nursing services, and medical records, must be supplied either directly by the HwH or through a contract with a third party that is not controlled by the host hospital or the hospital system that owns both the host hospital and the HwH.

Hospital within hospital rules should not be viewed as onerous. Rather the rules have allowed for the condominiumizing of existing buildings, which is in the best interest of public policy. Strict compliance with the federal rules only helps to ensure the long-term viability of the specialty hospital within hospital venue.

[12] Note that the HwH can purchase pharmaceuticals and pharmaceutical supplies on its own, but have the drugs and supplies delivered to the host hospital's loading dock and transferred to the HwH's pharmacy by host hospital personnel without the transaction being considered a purchase of the drugs and supplies from the host hospital.

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