

## Segregate building costs and capture savings

By Mark A. Master, CPA &  
Sheldon H. Eveloff, CPA

Published September 2003

- React to this article in the [Discussion Forum](#).

If your practice is preparing to buy, build, or remodel a medical facility, you may want to consider a cost segregation study. Cost segregation studies are designed to accelerate income tax depreciation deductions, providing you with maximum cash flow.

A cost segregation study is a means of breaking down total building costs and categorizing them into structural and nonstructural assets. Generally, structural assets are classified as real property but nonstructural assets are considered personal property.

Cost segregation studies offer numerous benefits. Property owners can substantially reduce taxable income, maximize current depreciation by accelerating deductions, increase cash flow and minimize property tax assessments since property tax bills are based on the value of real property. And with the additional 30 percent bonus depreciation available under the Job Creation and Worker Assistance Act of 2002, a cost segregation study is especially beneficial between now and Sept. 11, 2004.

Health care practices have another valuable opportunity, courtesy of the IRS, if you constructed or purchased real estate in a prior year but did not take advantage of a cost segregation study. This IRS gift horse allows you to deduct depreciation amounts that a practice was legally entitled to but did not claim (e.g., due to erroneous property classification as a 39-year depreciable building). This cash flow windfall is available to you even though the statute of limitations previously closed on the property construction or acquisition year. Qualified cost segregation professionals have the engineering and appraisal

skills to "carve out" the overlooked shorter-life assets and file the necessary IRS paperwork to recover unused tax deductions.

### **Valuable Tax Savings Imbedded in Buildings**

A health care practice's real estate holdings may constitute a huge capital investment. With an engineering-based cost segregation study, it is possible to maximize the real property's financial return by generating significant cash flow savings. Cost segregation professionals generate cash tax savings by carving out shorter-lived assets (qualifying for 5-, 7-, or 15- year write-off periods) that are normally imbedded in a building's construction or acquisition costs (generally depreciated over 39 years).

You can "mine out" these buried tax savings from:

- New buildings presently under construction.
- Existing buildings undergoing renovation, remodeling, restoration or expansion.
- Purchases of existing properties.
- Office/facility leasehold improvements and "fit outs."
- Post-1986 real estate construction, building acquisitions, or improvements where no cost segregation study was performed (even though the statute of limitations previously closed on the property construction/acquisition year).

Based on the results of previous cost segregation studies, for every million dollars of property reclassified for faster depreciation write-offs, the present value of increased cash flow from income tax savings approximates \$230,000.

### **Reclassifying Assets**

In the case of medical buildings, many assets can be properly reclassified as nonstructural or personal property and, therefore, eligible for depreciation over five or seven years, rather than the 39 years required for nonresidential real property. This means

property owners get larger tax deductions sooner, with significant savings in the first year.

Land improvements, which can be depreciated over 15 years, can also be segregated from real property. Land improvements include exterior lighting, parking lots, walkways, fencing and landscaping.

Here's an example of the potential savings that can be realized by reclassifying \$100,000 in real property as personal property. First-year deductions on real property would total \$2,564, based on a 39-year depreciation schedule. But assume that the \$100,000 is reclassified as seven-year personal property.

- If otherwise eligible, the taxpayer can take the Internal Revenue Code Section 179 deduction, which allows expensing up to \$25,000 of original costs in the first year.
- The property (if new) qualifies for the 30 percent bonus depreciation on the remaining basis (\$22,500).
- By applying the seven-year depreciation schedule to the remaining amount (\$52,500), a taxpayer ends up with \$55,000 in first-year deductions as opposed to \$2,564.

As you can see, being able to increase and accelerate deductions in the short term means more cash available to your business now.

### **Timing Considerations**

The best time to perform a cost segregation study is when you begin planning to buy, build, or remodel a medical building. It's easier to value and segregate assets at that point and to secure supporting documentation such as drawings and blueprints.

Building owners may also be able to work with their contractor in the planning stages to make strategic decisions that result in more assets qualifying as personal property. For instance, track lighting could be classified as personal property, but not fluorescent lighting.

Sometimes personal property is thought of rather narrowly as furniture and other moveable equipment. While these are valid examples of personal property, the category encompasses much more. Just about anything within a building that exists to support medical equipment can be considered personal property and, therefore, eligible for accelerated depreciation.

Examples include: site preparation costs; associated labor and overhead; structural modifications for equipment, such as reinforced flooring or lead shielding for radiology; specialized heating, cooling or ventilation; and electrical or plumbing components necessary for oxygen equipment, dental chairs or laser equipment.

During a cost segregation study, the following takes place:

- Physical inspection of the property.
- Examination of architectural/engineering drawings and specifications for potential asset reclassification.
- Analysis of cost data, including the contractor's application of payments, change orders, owner-incurred costs and indirect disbursements.
- Preparation of an itemized list of property qualifying for shorter-life classification based on relevant income tax authorities.
- Apportionment of direct labor, material components and indirect costs based on engineering drawings and specifications.
- Reconciliation of total costs per the engineering analysis to capitalized project costs.

### **Support for Cost Segregation**

A pivotal 1997 tax case involving Hospital Corporation of America (HCA) clarified guidelines on classifying and depreciating personal property, which has been a boon to those in the medical industry seeking to maximize their personal property deductions.

The ruling found that HCA correctly classified as personal property items associated with hospital equipment including: portions of the electrical system; television wiring; telephone equipment; carpeting; vinyl wall and floor coverings; kitchen plumbing connections and exhaust hoods; patient corridor handrails; and accordion-style room dividers.

In recent years, the Internal Revenue Service also simplified procedures allowing taxpayers to make changes to their accounting methods and retroactively claim "catch-up" depreciation if they missed deductions they were eligible for in previous years.

In general, high-value properties and those recently placed in service yield the greatest benefits from a cost segregation study, but cost segregation produces savings in a variety of situations.

If you are planning to buy, build, or remodel a medical building, ask your tax advisor whether a cost segregation study might be worthwhile for your specific circumstances. Although these studies are detailed and complex, your CPA can coordinate the process for you, freeing you to sit back and enjoy the money-saving benefits.

### **Benefits of Cost Segregation**

With a qualified cost segregation study, indisputable evidence for massive tax savings are documented that withstand governmental agency scrutiny. Cost segregation professionals provide full documentation, employing engineering and cost estimating procedures recognized in IRS rulings and judicial decisions. A complete "audit trail" will trace derived costs from contract documents and other source data. And, property is categorized into shorter-life classes based on applicable tax authorities.

Studies are designed to:

- Maximize current depreciation through accelerated deductions.
- Reduce taxable income.

- Minimize property tax assessments.
- Increase cash flow.

*Mark A. Master, CPA, is Partner-in-Charge of Business Advisors to Physician Practices, a division of Goldenberg Rosenthal, LLP. Sheldon H. Eveloff, CPA, is Partner-in-Charge of Management Consulting Services at the firm, located in Jenkintown, Pa.*

## [Free Offer! Get Daily News Briefs by Email](#)

© 1996 - 2005, Physician's News Digest, Inc. All rights reserved.

[Delaware Valley Edition](#)

[Cover Story](#)

[Spotlight Interview](#)

[News Briefs](#)

[Editor's Notebook](#)

[Commentary](#)

[Medicine & Computers](#)

[Medicine & the Law](#)

[Medicine & Business](#)

[Personal Finance](#)

[Texas Edition](#)

[Cover Story](#)

[Spotlight Interview](#)

[Medicine & Computers](#)

[Medicine & the Law](#)

[Medicine & Business](#)

[Personal Finance](#)

[Western PA Edition](#)

[Cover Story](#)

[Spotlight Interview](#)

[News Briefs](#)

[Editor's Notebook](#)

[Commentary](#)

[Medicine & Computers](#)

[Medicine & the Law](#)

[Medicine & Business](#)

[Personal Finance](#)

[Recruitment](#)

[CME](#)

[Discussion](#)

[Email](#)

[Search](#)

[Archives](#)

[About PND](#)

[Advertising](#)

[List Rentals](#)

[Subscriptions](#)