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Health Care Providers Can Enjoy Cash Flow and Tax Savings

For health care providers who have purchased, constructed, or substantially renovated a building since 1987, a recently released revenue procedure, coupled with a landmark tax court case, provides anew reason to undergo a cost segregation study that could result in significant and immediate cash flow and tax savings.

While the enactment of the Tax reform Act of 1986 eliminated the Investment Tax Credit (ITC), it substantially altered the depreciation system for real and personal property by classifying assets into nearly 130 different categories, each with its own depreciable life. This pattern of depreciable lives is known as the Modified Accelerated Cost Recovery system (MACRS).

In the landmark tax court case *Hospital Corporation of America, 109TC 21 (1997)*, the court held that if the property would have qualified as tangible, personal property under the repealed ITC, that same property would also qualify as tangible personal property under MACRS. In addition, a 1999 IRS Revenue Procedure allows real estate owners to automatically go back to closed tax years and “catch up” the entire omitted depreciation, without amending tax returns.

A cost segregation study will identify and price nonstructural elements and exterior improvements, making it possible for property owners to maximize their depreciation deductions. The study reclassified as many of the related cost as possible from building cost to personal property and exterior improvements. In addition, indirect construction cost such as construction period interest, general conditions, architecture, and engineering fees are allocated on a pro rata basis to the assets identified as non-structural. By maximizing their depreciation deductions, building owners increase their cash flow by paying less income tax during the early years of a building’s depreciable life. The owner is also eligible to play “catch up” for depreciation errors made in prior years.

Under today’s guidelines, a commercial building is depreciated for tax purposes over 39 years (27 ½ years for residential real estate). Upon segregation of tangible personal property and exterior improvements from a building’s cost, companies realize the benefits of deducting accelerated depreciation on assets otherwise lumped together with a building’s cost. Within the health care industry, 20 to 40 percent of building cost can be segregated into five, seven, or 15-year life instead of a 39-year life.

Examples of tangible personal property include nurse call system, wall coverings, electrical and plumbing cost that relate directly to the medical equipment, flooring, movable wall partitions, and appliances. Example of exterior improvements include sidewalk, drainage, parking lots, landscaping, road, sire utilities, fencing, and outdoor lighting.

The savings from an accelerated recovery can be quite significant. Take the following industry examples:

Nursing Home

Eligible assets identified include \$897,000 of construction cost as 15-year land improvements, and \$750,000 as five and seven-year personal property, which resulted in a present value tax benefit of \$220,000

Assisted Living

For a newly constructed \$7.9 million facility, consultants identified in excess of \$1.5 million of cost for a five or 15-year property. The tax deferred savings over a four-year period exceeded \$280,000, which results in a present value tax benefit of \$190,000.

Medical Offices

Consultants saved this medical group \$183,000 in present value tax savings on its \$4.1 million medical practice facility. Assets reclassified from the conventional 39-year tax life to five and 15-year lives, exceeding 24 percent of the total project cost.

Real estate investments best suited to undergo a cost segregation study include:

- Commercial property purchased or constructed since January 1, 1987;
- Is either historically or prospectively tax profitable;
- Has a least \$1 million in cost basis of property to be segregated.

Other factors to be considered when deciding to undergo a cost segregation study include a profitability of the entity or its shareholders, passive activity rules,

early disposition, and other tax-related situations.

For additional information regarding cost segregation studies and their effect on our business, contact your local consulting services provider.