EKS&H
AUDIT | TAX | CONSULTING

7979 E. Tufts Avenue, Suite 400
Denver, Colorado 80237-2521
P: 303-740-9400
F: 303-740-9009
www.EKSH.com

How Healthcare Entities Can Use Cost Segregation to Reduce Taxable Income

In 1997, a landmark decision in the case *Hospital Corporation of America v. Commissioner* determined that businesses could use cost segregation studies to compute depreciation and, thus, decrease taxable income.

Based on the ruling, cost segregation methodologies previously used to allocate the cost of a building between structural components and investment tax credit (ITC) property can now be used for depreciable assets.

By using cost segregation to differentiate between building and asset expenses, healthcare entities can lower their owed taxes, thereby increasing cash flow. For example, rather than applying a standard 39-year depreciation to a medical office building and everything attached to it, the building owner or administrator may apply a shorter schedule to items such as carpeting; decorative lighting; specialty outlets; and, in some cases, utilities. Doing so defers payment related to their tax burden and enables them to retain more cash to put toward immediate expenses.

To take advantage of cost segregation, a healthcare entity (such as a hospital, doctor's office, laboratory, or long-term care facility) must have taxable income and must have spent at least $500,000 for one of three scenarios: (1) purchase of an existing building, (2) construction of a new building, or (3) completed major improvements to an existing property. In all of these cases, documentation is extremely important, so owners and administrators should keep careful records to share with tax professionals.

Asset Eligibility Requirements

Let's take a look at just what types of expenses can and cannot be assigned a condensed depreciation schedule. Generally, anything movable, dedicated to hospital or business purposes, decorative, or easy to remove, can be considered a 5-year asset.

For example, an ornamental chandelier, though it provides light, is not necessary for office functioning, because other lighting is available; therefore, it may be considered decorative. Electrical outlets meant for a specific purpose that wouldn't be needed in a standard office building (such as in a ceiling for dental machinery) can be considered dedicated. Some plumbing fixtures, such as emergency eye wash stations, can also fall into this category. Carpeting, because it's easy to remove, could be eligible for the shorter tax life, while tile flooring may not be. Standard lighting and restroom plumbing that would be needed for any type of office environment would likely not be eligible. Some items, such as power outlets, may fall into a questionable territory as they could be used for dedicated equipment but also standard building equipment. Items considered to be personal property, and/or that a business would take with it if it moved, such as chairs, tables, sofas, equipment, and computers, would not be included in a cost segregation study.

Cost Segregation Studies

The key to determining which items are eligible for accelerated depreciation is a cost segregation study, which takes place after construction or the purchase has been completed. An **engineering based study** is the most accurate and effective at identifying and reclassifying property assets to shorten the depreciation time for taxation purposes and reduce current income tax obligations. The primary goal of a cost segregation study is to identify all construction-related costs that can be depreciated over a shorter tax life than the 39-year building standard.

The criteria for classifying assets is not always concrete, so engineers and accountants who provide this service tend to use "generally accepted" rules, rather than one particular code.

Typical Expense:	Depreciation:
Specialized Wiring	5 year
X-ray Shielding	5 year
Internal Communication Systems	5 year
Dedicated Plumbing	5 year
Vinyl Wall and Floor Coverings	5 year
Accordion Doors and Partitions	5 year
Parking and Landscaping etc.	15 year

Case Studies

Two recently completed EKS&H cost segregation studies illustrate the potential cost savings.

Medical Office Building A

The cost to build Medical Office Building A in Colorado was very high because of its rural location. As a result, utilities and paving had to be extended to the area. The total project cost was $18.5 million. The engineering based cost segregation study revealed that $2.5 million of assets — including exterior plumbing, water, and waste systems — could be depreciated on a 15-year schedule. The study also found $2.6 million in assets that could be depreciated on a 5-year schedule. The tax adjustments made possible with these findings decreased the taxable income on the hospital, increasing its available cash balance.

Hospital A

Hospital A, located in Wisconsin, recently finished an expansion. Fewer assets could be counted as 15-year property than in the Medical Office Building A example, because utilities to the area already existed. However, approximately $500,000 of the total $9 million cost of the addition were attributed to a 15-year schedule, and $2 million were attributed to a 5-year schedule.

Conclusion

Cost segregation can help healthcare entities reduce the tax burden related to building ownership and the resulting savings can enable them to allocate cash to current activities, such as purchasing equipment, developing new patient initiatives, and expanding their reach. Because of the complexity of this method, owners and managers should work with engineering-based cost segregation and tax professionals who have experience in getting the best results for healthcare entities.

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