OWNING YOUR OWN BUILDING IS LIKE MONEY IN THE BANK

A not-so-new development in the tax code is giving doctors a powerful tool for maximizing their investment in their office buildings.

By Robert W. Coleman, CPA

Considering all the economic uncertainty caused by the events of the past year — terrorists, accounting problems, corporate bungling, and market fluctuations — many doctors are looking for inventive ways to improve the financial health of their practice.

One innovative method that has surfaced from the murkiest depths — the tax law — is a cost segregation study. Although cost segregation studies are hardly new, recent developments in tax litigation have given doctors who own their own buildings a valuable tool to maximize the tax benefits of such a large investment.

What is a cost segregation study?
Under current tax law, the costs of a building are written off over a 39-year period. Typically, building finance arrangements are shorter, so the doctor ends up paying for the building over 20 years and deducting the building over 39 years. Obviously when deductions are lower, taxable income and taxes are higher. Here's where a cost segregation can be beneficial.

A cost segregation study is the process of reviewing and identifying the costs a doctor incurs to acquire, construct, or expand a dental facility that qualify for a shorter write-off period, from 39 years to five, seven, and 15 years. By speeding up the deductions, the doctor shelters larger sums of income now rather than later. The tax savings can now be used for other purposes like funding your retirement plan.

The landmark case on which most cost-segregation studies are based is *Hospital Corporation of America, Inc. (HCA) v. Commissioner (109 TC 21)*. In this case, the court allowed costs like plumbing and electrical systems that typically are classified as structural components of the building (subject to a 39-year write off) to be included with the costs of the equipment, furniture, fixtures, etc. (subject to five, seven, and 15-year write off) that they function to support.

Because these costs can be substantial, a "specialty use building" such as a dental facility usually yields the highest benefits. The HCA case provides a good source of ideas for cost allocation; the IRS recently announced its acquiescence to the theory of HCA.

How does it work?
The analysis begins with a review of the detailed construction records and blueprints of the building to isolate the various components that may qualify for the shorter depreciation periods.

After the plans are reviewed, the facility is inspected to gather general information regarding its basic structure and to identify specific short cost recovery items, such as plumbing, to support the segregation recommendations.

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The next step is to classify the segregated items into the proper depreciation classes according to the tax code. These items include all property for which there is substantial tax code authority — a "slam dunk" — and other items that have a realistic possibility of being sustained administratively or judicially if challenged by the IRS on their classification.

The last step is to match the total cost to build the building with the sum of the building pieces and to allocate indirect "soft" costs such as architect and engineering fees, permits, insurance, etc. to the segregated assets.

Will a cost segregation study be beneficial?

Obviously, the higher the building cost, the higher the tax benefit. Most building costs need to be greater than $400,000 or so for the study to be cost effective. The studies for dental buildings that I have been involved in have resulted in a net present value tax savings of $25,000 to $60,000 depending on the building size. The study can be performed on any building or renovation constructed since the 1986 Tax Reform Act was in effect.

This year, the IRS has issued two Revenue Procedures that are favorable to cost segregation studies for these pre-existing buildings. Basically, the IRS allows the doctor to make the classification change with no IRS preapproval and recoup all the deduction difference from prior years in the current year. Previously, the recovery deduction would have to be spread evenly over the subsequent four years. In addition to the revenue procedures, the Job Creation and Worker Assistance Act of 2002 permits an additional 30 percent, first-year depreciation allowance on property with recovery periods of 20 years or less that was placed in service after September 10, 2001. Property classified as five, seven, and 15-year property in a cost segregation study will qualify for the additional first-year depreciation.

Who can do a cost segregation study?

As with all issues involving the IRS and the tax code, documentation and justification of the positions taken are critical and must be included in the final report. The doctor must remember that the IRS has cost engineers and appraisers on staff, so the entire documentation must be an organized team effort, perhaps with several professionals contributing their expertise. Because the positions must have a realistic possibility of being sustained if challenged, and because IRS opinions on what qualifies may differ, an engineering knowledge of the element, as well as knowledge of the relevant tax law, regulations, revenue rulings, and case law, is needed.

Cost engineers are particularly well suited to perform cost segregation analysis. They possess the strong analytical and organizational skills required, the knowledge of how a facility is built, and the ability to estimate construction costs. Initially, you can contact your tax advisor to see if he or she offers this service or knows of someone who does. Some larger accounting firms are also set up to offer this type of service. If you are referred to an engineer, make sure the firm has a track record of success. The engineer that I work with has done about 1000 studies, has had only six examined by the IRS, and has a 99 percent approval rating.

The key to maximizing the benefit from a cost segregation study is to have the experts do it. Given all the other current economic turmoil, it's hard enough to sleep at night. A well-organized and documented study that will hold up in an examination can give you peace of mind, as well as the tax benefits should the IRS come calling.

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