WEBINAR RECAP

What You Need to Know about Real Estate and Construction for Your Healthcare Practice

ABOUT THE WEBINAR

TOPIC: What You Need to Know About Real Estate and Construction For Your Healthcare Practice

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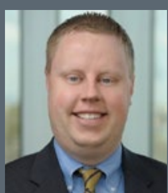

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Occupancy expenses are usually the second-largest line item on most healthcare practices' profit and loss statements, which is why choosing to buy real estate is a complex decision that every practice will likely have to go through at some point.

To help you gain insight into whether you are ready to buy real estate, we are going to walk through what should be considered in regard to real estate ownership and the construction of the location.

A recent PNC Bank webinar explored the factors that impact lease, buy and expansion decisions, so you can learn what you need to know about real estate and construction for your healthcare practice.

Moderated by PNC Bank's Kevin T. Wills, senior vice president, Healthcare Territory sales manager, this webinar included expert insight into healthcare facility real estate, financial services and facility construction. The session discussed the following:

- How tax treatments work
- What to keep in mind when deciding to buy or lease
- Common pitfalls to avoid

Inside, we provide an overview of the webinar's topics and takeaways. Keep reading for facts and expert-backed insights so that you can make informed decisions as you work through your own practice decisions.

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HOW TAX TREATMENTS WORK

How buying or leasing can affect your tax liability is an important consideration, especially if you find one route is likely to save you much more money. According to Jake Sciaudone, CPA and manager at KSM Business Services, the tax treatment on leases versus new construction is very different.

Tax Treatment on Leases

Sciaudone explained that a lease is pretty straightforward when it comes to how you can lower your tax liability. The main way you are going to do this is by deducting your monthly lease payment.

Another time taxes can come into play is when it comes to improvement allowances from your landlord. There may come a time when you have to negotiate different allowances for your future improvements, whether you're first occupying the building or you're 10 years into tenancy and are looking to renew. In that case, you will likely hold that lease on your operating entity side rather than setting up your own real estate entity to hold that lease.

"The one complexity I would say that comes from the lease side is going to be the allowances for the improvements," Sciaudone said. "It's always important if you are receiving some sort of sum of money, to do some type of improvement, that you consult your tax advisor to make sure you can avoid having to pick up that lump sum as taxable income. Because the last thing we want is for you to get a $500,000 allowance from your landlord and have it structured in some sort of way where that $500,000 turns into a lump sum of income for you to recognize in the current year."

Tax Treatment on Owned Property

When you own property, things can get more complex come tax season. To start, you end up having some type of depreciable basis.

So if you buy a building for $1 million, you are going to depreciate that $1 million over a certain number of years. Rather than having some type of monthly lease payment, your depreciation expense acts as a sort of monthly, noncash expense.

You will be able to deduct your monthly principal payment, but only the interest portion. The principal amount will not be deductible. That is just a repayment of a loan. The interest portion can be subject to some type of limitation under Section 163(j).

Next, you would deduct your depreciation expense. "You will likely create a separate entity to hold the real estate," Sciaudone shared. "At least that's what we see most of our clients do." Then if you have those separate entities — an operating entity and a real estate entity — you will likely set up your operating entity to pay some type of rent to your real estate entity and typically the goal is to structure that rent in a way where your real estate entity breaks even.

Do a Cost Segregation Study

To help reduce your tax liability, Sciaudone recommends doing a cost segregation study. With a cost segregation study, the whole goal is to shift depreciation from later tax years into the current tax year — or at least tax years that are coming up sooner rather than later.

For example, when you buy a building for $1 million, you are typically going to depreciate it over 39 years. With a cost segregation study, you break down that building into different components. Those components would be your tangible personal property which you depreciate over 5 or 7 years. Your land improvements would be over 15 years, or if you are doing a major renovation of a qualified improvement property, it would be over 15 years.

When it comes to personal property, land improvements and qualified improvement property, not only do they have shorter depreciable lives but they are also eligible for bonus depreciation, meaning you could potentially depreciate or expense 100% of those costs in year one if you do this in 2022.

Starting in 2023, bonus depreciation is going to start decreasing by 20% per year, so for 2023, it'll be 80%. To put these numbers into quick perspective, if you buy a building for $1 million and the cost segregation study identifies $100,000 of personal property in the building in 2022, you can expense that $100,000 in 2022 rather than expensing it over 39 years.

Finally, on the cost segregation side, you have a potential rate play where you are taking these depreciation deductions as ordinary deductions — meaning at your ordinary tax rate. Then on the back end, if you sell the property for enough money years down the road, you will recognize the gain as a capital gain rather than an ordinary gain.

Navigating these types of tax moves can be challenging, so it's best to consult a professional with experience in this space.

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GREEN OPPORTUNITIES

When building or making an improvement to your healthcare practice, you can choose to incorporate environmentally friendly elements that can help you save on taxes.

Sciaudone noted that the Section [129(d)] deduction tends to be the most accessible deduction for owners of commercial properties. "This is a deduction that relates to the efficiency of the shell of the building, your lighting, your plumbing and your HVAC, and can provide a deduction in 2022 of up to $1.88 per eligible square foot," Sciaudone shared. Now that the Inflation Reduction Act has been in effect, since January 1, 2023, that deduction has increased to $5 per eligible square foot.

There are a lot of new caveats that you have to navigate to earn that $5 per square foot, but it's definitely possible. We are still waiting for more information about what exact improvements and standards Congress and the IRS are going to focus on for this deduction in 2023 and beyond, but it is important to know it may make sense now for the buildings with smaller square footage to work toward achieving energy-efficient standards.

The other component of a green opportunity you need to consider is working with the local municipalities and states to learn more about the different credits and incentives that may be available to you.

Many utility companies and state governments are going to provide some type of credit if you incorporate solar panels or another type of efficient system or geothermal energy into your property. You can work with your local government to figure out what type of rebates and credits and incentives they can provide you for your state taxes, but you can also research what options you have for earning federal tax credits and other perks.

CONSIDERATIONS WHEN CHOOSING TO BUY OR LEASE

A big question many medical practice owners have on their minds is whether or not it's better to purchase or lease their healthcare practice.

Ken Jorgenson, national director, CARR, warned that there is no one-size-fits-all answer to this question. He noted that many different determinations go into making this decision. You may need to ask yourself:

- How does each option affect cash flow?
- What will my monthly figures look like?
- What is the annual figure after tax and before tax?
- What are you cutting a check for?
- What can you expect on the back end after you do your taxes?
- What are your short-term and your long-term goals?
- How do those play into the discussion?
- What about principal paydown and equity?

It is also important to keep the tax implications of both options in mind, and you need to have an exit strategy in place. For example, if you know you want to retire in 2 years, then you likely won't want to take on a ground-up project. If, however, you aim to retire in 20 years, it may be beneficial for you to decide that you want to own your practice for now, and when you retire, you can rent out the property so you can continue to earn income as a landlord.

There are tax implications whether you choose to buy or lease your healthcare practice, so you want to make sure that you evaluate those in detail. "So I guess the bottom line here is, is it better to purchase or lease? The answer is yes," Jorgenson said. "We need to figure out what your situation is and kind of walk through the numbers that way."

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BENEFITS OF OWNING

If buying property for your healthcare practice is something you are interested in, these unique advantages are worth considering.

- **Monthly payments lead to principal.**
  Whenever you make a monthly mortgage payment instead of a lease payment, you build principal. When you make lease payments, you don't build any principal because you are making payments to a landlord, not on a bank loan.
- **Balance sheet increases.**
  Every month that you continue to build equity, you increase your balance sheet, and over time, as the property grows in value, you will expand your balance sheet even more.
- **No more landlord negotiations.**
  Not having to deal with a landlord when you want to make decisions about your practice is a huge benefit.
- If you want to do construction, expand or sell your practice, you don't have to consult a landlord. You also don't have to worry about negotiating lease terms every couple of years. When you own, you call the shots.
- **Increased flexibility to choose when you sell.**
  One fun surprise many tenants discover when leasing is that there can be a clause hidden in their lengthy lease that says that the landlord has the right and the ability to not assign the lease to whoever you are going to sell it to. Additionally, they may want you to pay a fee to assign that lease. They can also require the buyer of your practice to meet certain criteria, so they potentially could stop the sale of a practice if you don't find their ideal buyer. These hoops you need to jump through can be detrimental to your progress if you're trying to move along into the next stage or season of your life. When you own your real estate, you can decide when the right time to sell is and who your ideal buyer is.
- **Generate an additional sellable asset.**
  Buying your healthcare practice location also helps you generate an additional sellable asset. If you decide to sell your practice one day, you can choose to sell both your practice and the property, or you could decide to sell the practice but remain owner of the property. This gives you the ability to charge the new practice owner rent if they want to remain in the space, or you can find a new tenant.
- **Growth potential.**
  As long as you properly maintain your building and you have purchased property in a desirable and growing area, you are very likely going to see increased value in your commercial real estate.

COMMON PITFALLS TO LOOK OUT FOR

If you decide to buy property to house your healthcare practice, it is very likely that you will require construction in order to adapt the space to meet your needs or to update a space to modern practice standards. Before kicking off a construction project, it can be helpful to keep the following pitfalls in mind. That way, you can avoid expensive and time-consuming headaches and timeline delays.

Some examples of pitfalls you can keep an eye out for include:

- **Not hiring an architect and engineer who understand local municipal requirements.**
  Misstepping here can lead to significant delays, so it's important your team is knowledgeable surrounding issues such as fire department access and traffic patterns, as well as what any municipal approval processes involve.
- **Not reading technical reports.**
  Even though reports, such as geotechnical reports, may not be your area of expertise, reading them is key to staying up to date on the project, and you should encourage all consultants to read them as well. These reports generally have summaries that are worth reading.
- **Not being an active participant in the site selection process.**
  You want to attend meetings with consultants and municipal representatives to ensure you're all on the same page about project needs and next steps. The aforementioned reports can include key information about major issues, such as soil or existing environmental issues, that you need to be aware of in order to actively participate when choosing a site for your healthcare practice.
- **Not delegating to other team members.**
  Many small business owners want to do it all and aim to control the entire process, but that just isn't possible. Practicing doctors have very long workdays, so it's really helpful to assign a team member to be your liaison and to help keep the process moving when you are busy.

NEXT STEPS: KEEP TIMING AND COST TOP OF MIND

Jason Sanderson, president, RWE Design Build, feels that two of the most important factors to keep in mind when planning construction for your healthcare practice are timing and cost.

“As builders and designers, those are usually our areas of expertise, where we are trying to keep our clients within a budget and keep them on schedule,” Sanderson said. “So you’ll hear me talk about how to build a good timeline, and how to build a good budget, and how to keep on track with those as you progress through the project process.”

Sanderson went on to explain that the success of the practice and success of the build really start with developing a good plan.

“When we first meet clients, we’ll try to ask them, what is your immediate need? And where they are at, there’s usually a current pain point.” These pain points can include outgrowing their space or not being able to reach suitable terms with their landlord during a recent round of negotiations. These needs can be immediate or focus on long-term goals like starting their own practice.

“We try to get our clients to think about a 3- and 10-year plan of where they see their practice beyond the next 5 years,” Sanderson noted. “So when you’re looking at spaces, you are not just focused on what your current need is, but where you think your practice will grow to with the success.”

To learn more about considerations surrounding buying a healthcare practice and pursuing construction projects, listen to **PNC’s recent webinar** about what you need to know about this space.

For more insights designed just for healthcare professionals, visit **pnc.com/hcprofessionals**.

To speak with a PNC Healthcare Banker, contact us at 1-877-566-1355.

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