



Reface, Remodel, or Rebuild Your Dental Office

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ABSTRACT Upgrades to a dental practice can range from a minor facelift to all new construction. Consulting a certified public accountant is important to properly account for all the various assets that go into a new office so the tax benefits from each can be optimized. After all the dust has settled, practitioners will be able to take pride in their new dental facility and enjoy their surroundings for many years to come.

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Chances are the practice purchased or started a decade or more ago is not housed in the office one would create if building it today. X-ray viewers have

been replaced by HD monitors. Patient education includes multimedia videos and computer imaging versus a picture drawn on a sheet of paper. Then there's the improved materials and devices, a host of other technological advances, and increasingly savvy patients with increasingly higher service expectations.

To compete in the world of dentistry today, one must take advantage of the tools available and think toward the future. Dentists need a state-of-the-art dental practice to deliver the modern care their patients are, or soon will be, demanding. What are the options and best-practice strategies for funding, constructing, and tax managing the accounts of today's ideal dental offices?

Upgrading the Existing Office

When planning to modernize an existing space, among the first decisions is whether the upgrade should be gradual or comprehensive.

The author, who is from San Francisco, learned that by the time the painters finish painting the Golden Gate Bridge, they have to go back to the other side and start all over again. On the other hand, one can only imagine what people might say if the planners simply closed the bridge for several weeks annually to paint it all at once. Similarly, dentists may decide to bridge the distance between reality and their ultimate goal by remodeling incrementally.

A CASE IN POINT: *Dr. Brown bought an older practice a few years ago. Knowing he was not going to move anytime soon, he decided to modernize his office over time. After familiarizing himself with his patients and practice, he began the upgrades. A new networked computer system was first, followed*

by a makeover in the reception area including new flooring, wall covering, artwork, lighting, and furniture. It made a huge difference. Later, he updated the operatories with new cabinetry and new equipment. Then came the lab, sterilization area, and restroom. Finally, he renovated his private office. By spreading his upgrades across two years, they were completed with almost no downtime.

Over time, like painting the Golden Gate Bridge, incremental upgrades can keep one's practice modern, optimally functional, and an enjoyable environment for the dentist, their staff, and their patients. In doing it in this manner, one is also protecting their investment, helping them realize full value of the practice when it is sold.

In other situations, incremental upgrades may not be ideal. For example, modifications that go beyond a cosmetic makeover require building permits and building permits begat building inspectors. One may need to do something as simple as removing a doorway to expand into adjacent space or as complex as an expansion with costly modifications like retrofitting. Either way, it might be easier to rip the proverbial Band-Aid off more quickly by planning an all-out upgrade, with no corners cut, and the building inspector prohibiting shortcuts anyway.

A CASE IN POINT: *Dr. Green wanted to add an operatory for hygiene. There was no adjacent space to expand into so she worked with a planner to reconfigure her existing office. Picture a "wave" making its way around a ball-park, that is how Dr. Green remodeled for her new operatory. They started with the private office behind the front desk and circled their way through the rest room, operatories, sterilization and lab, and a large room that doubled as a staff lounge and storage room. By reducing the size of each room and incorporating more modern and efficient cabinetry, Dr. Green was able to add the new operatory. While this*

seemed like a fairly small project, it required all the same aspects of building a brand-new office, including blueprints and building permits. With careful planning and preparation, the work was completed over the course of an extended holiday break, about four weeks in all.

Taking the New Office Approach

But what if remodeling the existing space doesn't make sense or isn't an option? What about a brand-new office? One advantage with this option is less worry about downtime. One may face a few days of lost production during the move or one may miss a desired target date for the grand opening, but with good planning and an excellent team, the transition or start-up can be achieved with minimum stress and disruption.

Whether relocating a practice or opening a new one, it's a major project. Over the years, the author has seen dozens of dental offices built in various settings including converted and rezoned homes, older buildings in need of retrofitting, new buildings, and shopping centers. Whatever the space, building a brand-new dental office is a serious undertaking.

That's one reason it's not a good time to pinch pennies when selecting a project team. Dentists can reduce their stress and enhance their results by hiring competent, dental-specific space planners, architects, and contractors. They'll probably cost more upfront, but professional, specialized expertise will save money in the long run by reducing costly changes, surprises, and mistakes. After all, the dentist is going to be in the office, day in and day out, for many years to come. Why not strive for perfection?

The Costs of Construction

Costs for building a brand-new office can vary depending on location, market conditions, local economy, and personal preferences. A four-operatory practice in

TABLE 1

Estimated Cost of Construction for Four-Operatory Practice

Leasehold improvements*	\$225,000
Cabinetry*	\$60,000
Equipment	\$200,000
Technology	\$100,000
Furnishings/décor	\$40,000
Contingencies & misc.	\$55,000
Total	\$680,000

* Leasehold improvements are estimated at \$150 per square foot and cabinets at \$40 per square foot.

approximately 1,500 square feet will probably look something like this (TABLE 1).

The author surveyed colleagues in the Academy of Dental CPAs (adcpa.org), which consists of 25 dental-specific CPA firms across the country, and found these numbers were fairly consistent. One should be careful about using per-square-foot costs as a frame of reference for leasehold improvements, however. Each contractor will have a unique interpretation of what to include. Focus on total project costs and have the dental architect give the contractors and vendors guidelines for their project quotes so they are all inclusive and comparable.

Financing the Project

One should be able to finance a project using one of the major dental lenders, or, if a dentist is well-established, a local bank. Lenders will hold the purse strings during construction to ensure the project is completed. A variety of loan programs, including options to defer the first three payments or to pay only accrued interest on the outstanding balance for the first six months — similar to a line of credit — are available. More complicated financing is available too, but here are some examples of typical loans and the corresponding monthly payments (TABLE 2).

If one pays "interest only" during the construction period, the loan payment will

TABLE 2

Examples of Typical Loans and Corresponding Monthly Payments

Loan Term (Years)	Fully Amortized Loan Payment	Payments Deferred for the First 3 Months
7	\$10,263	\$10,744
10	\$7,895	\$8,177
15	\$6,112	\$6,279

TABLE 3

Sample of Dental Office Depreciation Schedule, Sorted by Useful Life

Asset	Cost	Useful Life (Years)	Annual Depreciation
Leasehold improvements	\$225,000	39	\$5,769
Contingencies & misc.	\$55,000	15	\$3,667
Cabinetry	\$60,000	7	\$8,571
Furnishings/décor	\$40,000	7	\$5,714
Equipment	\$200,000	5	\$40,000
Technology	\$100,000	5	\$20,000

be calculated on the balance outstanding after all the funds have been disbursed and then amortized over the remaining term.

When starting a practice from scratch, one shouldn't forget to arrange for sufficient working capital. There are hybrid loan programs with deferred or stepped-up payments that can help with cash flow when starting from scratch. But be careful. Payments are calculated by adding any unpaid (accrued) interest to the amount borrowed, making the loan more costly in the long run.

A Taxing Challenge

Whether remodeling or building, it pays to first take a good look at one's taxes. Maybe it's tempting to postpone that step, but if one is wincing from project costs, it should actually feel good to know any tax-related benefits available from the improvements being planned have been considered and maximized. This is where a dental-specific CPA can really shine. He or she should have in-depth expertise in the many important tax considerations associated with building a dental office, and should communicate

them to the dentist, their architect, and contractor. Tax planning should happen before one begins the projects so it can be smoothly integrated with the efforts.

Many available opportunities are related to the appropriate use of depreciation.

Depreciation Overview

Depreciation is a "noncash" expense, designed to provide for the replacement of assets over time through reduced taxes. When acquiring new assets for one's practice the cost of those assets is deducted (depreciated) over an assigned number of years (useful life). The author's sample dental office depreciation schedule is as follows, sorted by useful life (TABLE 3).

Converting 39 Years Into Five

Notice the difference between the depreciation values on the 39-year leasehold improvements versus the five-year equipment. What a difference 34 years makes. What if some of the 39-year property could be moved into the five-year category for a write-off that one could actually use before retirement? Thanks to the Hospital Corporation of America (HCA), it's possible.

In 1997, the tax court sided with HCA against the Internal Revenue Service, providing legal support to use cost segregation studies for computing depreciation. Basically, HCA won their argument that certain expenses, such as plumbing and electrical, were necessary for the operation of hospital equipment and therefore, should be considered part of that equipment and depreciated with it over five years instead of 39.

In a new dental office, one needs water and electricity in the operatories, lab, and sterilization area along with air, suction, and maybe nitrous oxide. A cost segregation study will assign the cost of improvements necessary to make the equipment operational to the same depreciation category as that equipment.

Furthermore, one can associate to those reassigned improvements a proportionate share of the project's soft costs, such as design and architectural fees, building and utility permits, and contractor supervision. They too are reassigned and depreciated over five years. So, if improvements specifically related to equipment operation equal 15 percent of the total improvements, one would include 15 percent of the soft costs in the calculation of the total costs included in the five-year equipment depreciation category.

Cost segregation is a specialized and valuable service provided by very few firms. It requires specialized knowledge of dental office construction.

A CASE IN POINT: *Dr. Black hired a dental-specific CPA who helped him determine that he could reallocate \$75,000 of the leasehold improvements and associated soft costs to the five-year depreciation category. By taking this action, he increased the annual depreciation he is allowed by \$13,077 and lowered his annual taxes by \$5,231 for the next five years (in the 40 percent bracket).*

Dr. Black's CPA also advised him he should depreciate the entire project cost over

TABLE 4

Statement of Cash Flows — Five-Year Depreciation

	Year 1	Year 6
Net income	\$200,000	\$300,000
Add depreciation	\$96,799	\$21,799
Subtract loan principal	\$78,028	\$110,615
Cash flow	\$218,771	\$211,184
Difference	\$18,771	\$(88,816)
Tax (at 40%)	\$(7,508)	\$35,527

the appropriate scheduled useful life and that he should not take additional first-year depreciation as allowed under Section 179.

Why not?" asked Dr. Black. His CPA replied, "The Section 179 deduction has been all over the map for the past decade and its future remains unknown. But in 2010 you are allowed to expense up to \$134,000. If you were to take the full \$134,000 deduction on your \$200,000 of equipment, this would leave you with only \$66,000 to depreciate over five years, or \$13,200 per year.

In other words, Section 179 is a double-edged sword. Dr. Black could get a big write off in his first year, but the trade-off is minimized deductions during the next four years, when he could probably use them to greater advantage when tax rates will be higher.

Fifteen Years and Counting

The 15-year depreciation category for contingencies and miscellaneous is sometimes used to depreciate start-up costs that don't fit into the other categories mentioned previously but pertain to the project.

Start-up costs are those incurred to investigate a business opportunity prior to that business opening. For example:

- Feasibility or demographic study costs, to identify potential new office locations;
- Real estate attorney fees in conjunction with one's new premise lease;
- Legal and filing fees related to incorporating; and
- Accounting fees for one's business plan and cash flow projections.

The author is often asked whether such costs can be deducted in the year they are paid, especially if it is the year prior to the new office opening. The answer is, it depends. The main determination is whether one is opening their first practice or moving an existing one. Start-up expenses incurred by dentists opening their first practice are not deductible when paid. Rather, they are deducted (amortized) over 15 years as in **TABLE 3**. However, for dentists already in practice and simply relocating, those same start-up costs are deducted as regular business expenses when paid.

Seven-Year Itches

Continuing with the sample dental office depreciation schedule, the cabinetry and furnishings and décor items in the seven-year category could have instead been depreciated over five years. The author prefers the seven-year depreciation for the following reason. A difficult, but important concept to grasp in accounting is the difference between the practice's taxable income and its actual cash flow. The "Statement of Cash Flows" is a report that reconciles taxable income with all the inflows and outflows of money. For example, with a seven-year loan at 7 percent interest, the Statement of Cash Flows would look like the one in **TABLE 4** for the first and sixth years after opening the new office.

This sample Statement of Cash Flows is overly simplified. But basically, one

starts with net income, add any depreciation (and amortization) and subtract the loan principal to arrive at available cash flow from the practice. Here are some additional insights regarding depreciation and loan principal:

- The big difference between depreciation in Year 1 and Year 6 is because all the five-year assets have been fully depreciated by Year 6. For the loan principal, the difference occurs gradually with the normal amortization of the loan.

- One does not write a check for depreciation. It is a systematic, non-cash deduction to help save for future expenditures, which is why it is added back in the Statement of Cash Flows.

- On the other hand, a monthly check is written for the loan payment, some of which is deductible interest and some of which is nondeductible return of principal. Since it lowers both the net income and cash, nothing is done about the interest. But the principal paid is subtracted since it comes out of the cash but has no impact on the net income.

The Statement of Cash Flows in **TABLE 4** assumes that the Year 1 net income is \$200,000, and that it has grown to \$300,000 by Year 6. In Year 1, when the depreciation is added and the principal is subtracted, there is \$18,771 more cash than taxable net income. By Year 6, the five-year depreciation is gone and the loan payment consists of more nondeductible principal than deductible interest, leaving the cash flow at only \$211,184. One has to pay tax on \$300,000 from cash flow of \$211,184. If the tax on that \$300,000 is \$120,000, the dentist only has \$91,184 to live on. Imagine how much worse it would look if one took the lion's share of depreciation in the first year, as allowed by Section 179.

Suddenly, seven-year depreciation and passing on a Section 179 Year 1 deduction

TABLE 5

Statement of Cash Flows — Seven-Year Depreciation

	Year 1	Years 6 and 7
Net income	\$200,000	\$300,000
Add depreciation	\$75,370	\$75,370
Subtract loan principal	\$78,028	\$110,615
Cash flow	\$197,342	\$264,755
Difference	\$(2,658)	\$(35,245)
Tax (at 40%)	\$1,063	\$14,098

are looking like good ideas. If all of the five-year assets were moved to a seven-year schedule and straight-line depreciation was elected instead of other accelerated methods (TABLE 5), the difference between net income and cash flow would be less dramatic in the last two years of the loan (\$35,245 instead of \$88,816).

Once the loan is paid off, the pain that results from this mismatch between taxable income and cash flow is alleviated.

One could also take out a 10- or 15-year loan to alleviate the pain with lower principal payments, but longer-term loans carry more interest expense. As an automotive advertisement says, “You can pay me (a little) now or you can pay me (a lot more) later.” Or, as one of the author’s clients described following his move into a brand-new facility, “Let’s do a slow burn this time around; it’s less painful.”

Other Tax Tips

Tax management isn’t all about depreciation. Here are a few other tax-related tips:

Section 44 Tax Credit

For eligible expenditures under the Americans with Disabilities Act, one may take a credit against tax equal to 50 percent of those expenditures, up to \$5,000 provided the dentist spent \$10,250. But the credit is suspended if the dentist is in Alternative Minimum Tax (AMT), which most readers of this journal are likely. As long as one is in AMT, the credit

is suspended for a maximum of 20 years, after which it becomes a deduction. The author believes it is wiser to take the depreciation deduction now rather than wait for the credit. Even if one finds themselves no longer subject to AMT, one only gets to take small bits of the credit at a time against future taxes.

The author cautions what should be considered eligible expenditures. These do not include new construction or most dental equipment. The purpose of the ADA is to remove barriers or obstacles to access, so one must think in terms of modifications to existing facilities.

Section 190

Also related to the ADA, the Section 190 provision of the tax code allows one to deduct up to \$15,000 spent on qualified expenditures for the removal of access barriers and for “minor improvements.” This means one can deduct such expenses in the year they are incurred rather than having to depreciate them over 39 years. “Minor improvements” means they are not part of new construction. So in the case of a brand-new office, think in terms of demolition. Examples might include tearing out noncompliant workspaces, front desks, restrooms, overly narrow hallways and doorways, and floor treatments (tile, carpet, linoleum) and replacing them with ADA-compliant improvements such as a lowered front desk workstation, non-slip flooring, handrails, bathroom fixtures, and other similar updates.

Business Energy Investment Tax Credits

Tax credits are available for eligible systems placed in service on or before Dec. 31, 2016. The credit is equal to 30 percent of expenditures, with no dollar maximum. Eligible solar energy property includes equipment that uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat. This law also allows taxpayers eligible for the business tax credit to receive a grant from the U.S. Treasury instead of taking the business tax credit for new installations. This credit is not affected by AMT.

Some Parting Gifts

The following are a few ideas that can apply to just about any dental office project undertaken.

Don’t Overlook Oversight

Don’t think for a minute this project will happen by itself. The dentist will be on a treadmill during the entire process with all sorts of distractions. Do whatever is necessary to maintain sanity, focus, and good nature, so that the patients, staff, and family are able to get through it too.

Go Green

The Leadership in Energy and Environmental Design Green Building Rating System, developed by the U.S. Green Building Council, provides guidelines and oversight to help one become a LEED-certified “green” facility. In addition to being good for the environment, it’s probably good marketing.

State Business Property Tax

Each California county assesses a tax on business assets very similar to the property tax for a home. One must file Form 571-L with the appropriate county by April 1 and pay the tax by Aug. 31. The

tax is assessed on assets owned on Dec. 31 of the prior year. In the new dental office example, the property tax would be in the neighborhood of \$6,000. Do not forget to include this amount in one's budget.

Office Makeover=Image Makeover

A brand-new office is like making a fresh start — for the dentist and their practice. Take full advantage of this by promoting one's new image among existing and potential new patients, particularly if new to the neighborhood. A qualified marketing consultant can help with this. A practice management

consultant can work with the dentist and their staff to develop fresh approaches to patient communications.

One will have worked very hard and endured a great deal of stress during the remodel or construction of a dental office. But brush off all that stress before seeing patients and convey enthusiasm for the new, state-of-the-art dental facility. ■■■■

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