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Ninth Circuit Affirms CCRC's GAAP Accounting Method for Recognizing Deferred Entrance Fees

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Although the Commissioner of Internal Revenue (Commissioner) has broad discretion over the approval of a taxpayer's method of accounting, that discretion is not unlimited, according to a recent Ninth Circuit decision[1] affirming a U.S. Tax Court ruling[2] in favor of an entity operating a retirement community. The Ninth Circuit and Tax Court rulings provide important lessons for accrual method taxpayers whose rights to income are conditioned on their performance, and especially for operators of for-profit retirement communities that offer to care for residents for the rest of their lives.

Continuing Life Communities Thousand Oaks LLC (Continuing Life) operates a continuing care retirement community (CCRC) in Southern California called University Village Thousand Oaks (UVTO) where elderly residents contracted for continuing care for the rest of their lives. During the years in question, the typical Residence and Care Agreement (Residence Agreement) between a resident and Continuing Life called for the payment of an entrance fee, of which some portion (usually 75%) would be returned to the resident or the resident's heirs upon the death or voluntary departure of the resident, and a portion called the Deferred Entrance Fee (usually 25%) *could* be earned by Continuing Life. To earn the Deferred Entrance Fee, Continuing Life had to provide lifetime care to the resident. If Continuing Life failed to satisfy that obligation, it had no right to any portion of the Deferred Entrance Fee. Expulsion of a resident, even for cause, meant that the lifetime care obligation in the agreement had not been fulfilled, and no Deferred Entrance Fee was earned.

Continuing Life was required by contract and by law to satisfy that lifetime care obligation. Under California law, a continuing care contract is defined as "a contract that includes a continuing care promise made, in exchange for an Entrance fee, the payment of periodic charges, or both types of payments."[3] A "continuing care promise" is defined as:

[A] promise, expressed or implied, by a provider to provide one or more elements of care to an elderly resident for the duration of his or her life or for a term in excess of one year. Any such promise or representation, whether part of a continuing care contract [or] other agreement . . . is a continuing care promise.[4]

The California Health & Safety Code requires the form of such agreement to be approved by the California Department of Social Services (DSS) and the filing with DSS of annual audited financial statements. For audited statements, income must be reported under an applicable Generally Accepted Accounting Principles (GAAP) method. In this situation, GAAP requires recognition of income from the Deferred Entrance Fees through amortization of such fees over the life of the resident.

Continuing Life maintained that while GAAP required recognition each year of a portion of the Deferred Entrance Fees over the lifetime of each resident, the remaining portion of the Deferred Entrance Fee should be recognized as taxable income only in accordance with the terms of the agreement, thus not until the resident died or elected to leave the facility. The Commissioner disagreed, arguing that the schedule showing the periodic increases in the amount of the Deferred Entrance Fee Continuing Life could earn also fixed the time for recognition of income, which the Commissioner claimed justified his change in Continuing Life's accounting method and the assessment of a deficiency. Continuing Life contended that the Commissioner ignored the provisions in the Residence Agreement that limited the conditions under which the Deferred Entrance Fee could be earned.

On competing summary judgment motions, the Tax Court held that the Commissioner's decision to reject Continuing Life's accounting method was an abuse of discretion. The Ninth Circuit, after briefing and oral argument, affirmed the Tax Court ruling on the grounds that Continuing Life's approach clearly reflected its income, and therefore the Commissioner had no authority to impose another accounting method on Continuing Life.

Detailed Facts

In California, CCRCs are subject to an extensive statutory[5] and regulatory scheme. CCRCs that violate these requirements can be subject to civil and criminal penalties.[6]

As noted above, DSS must approve all CCRCs' continuing care contract forms prior to their use. In establishing the provisions governing CCRC continuing care contracts, the California Legislature found:

Because elderly residents often both expend a significant portion of their savings in order to purchase care in a continuing care retirement community *and expect to receive care at their continuing care retirement community for the rest of their lives*, tragic consequences can result if a continuing care provider becomes insolvent or unable to provide responsible care.[7]

It is within this legislative framework that Continuing Life's relationship with its residents exists.

The Residence Agreement, approved by DSS, fixed the terms of the relationship between UVTO and the resident. It established UVTO's obligation to provide lifetime care, which included the UVTO resident's personal and non-assignable right to live in their chosen UVTO unit, a daily meal at UVTO, health care services, and the right to share and use UVTO's grounds and common facilities, subject to the terms and conditions set forth in the Residence Agreement, including payment of fees and cancellation/termination provisions.

Each UVTO resident paid an upfront amount (Contribution Amount) at the time the resident began occupancy at UVTO and an ongoing monthly amount (Monthly Fee). Continuing Life set the Contribution Amounts for the facility based on a variety of factors, including the cost to construct the UVTO campus, local housing market conditions, general economic conditions, the demand for CCRC units, and the prices at competitor CCRCs. A resident's specific Contribution Amount was based on the size, floor plan, and location of the resident's unit within the facility. The Monthly Fee was set using the community's operating cost, the prior year's per capita costs, and other economic indicators, as required by the Health & Safety Code, and was subject to periodic increases. Even if the resident required additional or supplemental services, such as transition to a skilled nursing facility, the resident's Monthly Fee continued to be charged at the lower independent living rate.

Under the terms of the Residence Agreement, UVTO residents entered into a joinder agreement in the University Village Thousand Oaks Master Trust (Master Trust), a trust administered by an independent trustee (Trustee). Each resident paid their Contribution Amount to the Trustee (not to Continuing Life) and became a grantor to the Master Trust.

The Master Trust Agreement authorized the Trustee to loan Master Trust assets to Continuing Life in an interest-free loan.[8] The Master Trust provided permanent financing for the UVTO campus and improvements thereto. Pursuant to the Master Trust Agreement, the Trustee had, and in fact exercised, sole discretion to evaluate the sufficiency of the collateral for these loans and to make sure that such loans did not violate any rule or principle of prudent trust management.

The Master Trust loan to Continuing Life was secured by a security agreement and a recorded deed of trust, which grants the Trustee "with power of sale, for the benefit of [the Lender] in all of [Continuing Life's] right, title and interest in and to the UVTO real property together with all right, title and interest which [Continuing Life] now has or may hereafter acquire to such [p]roperty," including all buildings, structures, improvements, fixtures and appurtenances, all present and future leases and rents from the property, and all intangible property and rights relating to the property. That deed of trust and the security agreement provided residents with a significant measure of protection in the event of the insolvency of Continuing Life.

Upon termination of a Residence Agreement, a UVTO resident's Contribution Amount was repayable from the Master Trust to the UVTO resident or the resident's heirs, less any Trustee fees, and less any portion of the Contribution Amount due to Continuing Life pursuant to the terms of the Residence Agreement. The portion of the Contribution Amount payable to Continuing Life upon termination of the Residence Agreement, if any was due, is referred to as a Deferred Entrance Fee in the Residence Agreement.

At the heart of the dispute was Continuing Life's use of the GAAP method of accounting that required Continuing Life to report the income that might be generated by receipt of the Deferred Entrance Fees from a resident to be amortized over the actuarial life expectancy of the resident, thereby requiring annual recalculation of each amortization schedule with respect to each resident still alive at the end of a year. The method was necessary for Continuing Life to have audited financial statements required by DSS.

The Legal Background

The key statutes were:

26 U.S.C. § 446. General rule for methods of accounting.

(a) General rule.--Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) Exceptions.--If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

26 U.S.C. § 451. General rule for taxable year of inclusion

(a) General rule.--The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.[9]

The key regulations were:

26 C.F.R. § 1.446–1 General rule for methods of accounting.

(a) General rule.

(1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. . . . Except for deviations permitted or required by . . . special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

26 C.F.R. § 1.451–1 General rule for taxable year of inclusion.

(a) General rule. Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy (all events test).

Tax Court Decision

The Commissioner’s main arguments before the Tax Court were that Continuing Life's method of accounting did not clearly reflect income and therefore the Commissioner, in his broad discretion, could substitute a method that did clearly reflect income. The Tax Court disagreed, and found that there was no reason to conclude that an accounting method consistent with GAAP accounting did not clearly reflect income within the meaning of Section 446.

The Tax Court noted that Treas. Reg. 1.451-1(a) requires inclusion in gross income when all events that fix the right to receive the income have occurred and the amount can be determined with reasonable accuracy. “[I]f, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made.” Thus, at the heart of the dispute was when Continuing Life had performed the services that entitled it to receive the Deferred Fee. That is, when did “all events” occur that fixed the right of Continuing Life to the Deferred Fee?

The Tax Court declared that California's regulation of CCRCs was important. Noting that the Supreme Court has held that state law can fix a liability for accrual accounting purposes, the Tax Court observed that the Residence Agreement was drafted to comply with California law and to obtain the approval of DSS, which is charged with regulating companies that promise to provide care “for the duration of [the resident's] life.”

The Commissioner urged that the schedule that fixed the amount of Deferred Fees Continuing Life could earn somehow also fixed its right to those fees. But the Tax Court confirmed that the schedule only fixed the ***amount*** of the fees and nothing in that section of the agreement fixed the obligation to pay them at those times. By the terms of the agreement, the resident became obligated to pay the fees when the resident died or elected to leave the facility. The Tax Court called the lifetime care obligation the “essential service” provided by Continuing Life and not merely a formality.[10]

Further, citing *Hallmark*,[11] the Tax Court noted that given the state law requirement to provide lifetime care, even near certainty that Deferred Entrance Fees would be earned and paid was not enough; Continuing Life had not yet earned the fees until the condition of lifetime care had been met. The Commissioner argued that the probability that Continuing Life would not meet its obligation was so low that the condition should be treated as merely a condition subsequent. Rejecting that argument, the Tax Court cited a 1947 decision, *Norbury Sanitorium v. Commissioner*,[12] where a father reached an agreement with a for-profit sanatorium to care for his developmentally disabled son for the rest of the son's life in exchange for monthly fees and $28,000 in bonds to be released from a trust upon the son's death provided that the sanatorium did not mistreat or neglect the son. The son died in 1944 and the sanatorium received the bonds. In *Norbury*, the then-Commissioner argued, and the Tax Court found, that the requirement to provide lifetime care meant that the sanatorium had to complete its promise to care for the son before recognizing the bonds as income.[13]

The Commissioner argued that *Highland Farms*[14] was the governing precedent. As with Continuing Life, the entry fee at Highland Farms that a particular resident owed was fixed in amount by the passage of time. Highland Farms was entitled to up to 20% of an entry fee, earned at fixed increments at the end of each of a resident's first five years. At the end of each year, Highland Farms moved the incremental portion of a resident's fee from a segregated advance deposit account to its general account. The Commissioner argued that the entire amount had to be included in income as received by the operator, but the Tax Court in *Highland Farms* ruled that the income became includable for tax purposes only as each portion became non-refundable. The Commissioner argued that the method of accounting in *Highland Farms* should govern Continuing Life, ignoring the precondition of providing life care. The Tax Court rejected that argument because the terms of UVTO's Residence Agreement were different and because Continuing Life lacked dominion over the funds, which were deposited with the Trustee and only paid over when a resident died or departed the facility.

The Commissioner tried to liken the Deferred Entrance Fees to advance payments in *Schlude,*[15] *American Automobile Association,*[16] and *Automobile Club of Michigan*[17] because the fees for which services might be performed were, in each instance, paid to the service provider, who might never be called upon to perform the promised services. However, as required by the Residence Agreement, Continuing Life provided services every day, including but not limited to, occupancy by each resident of their own private suite. Furthermore, as noted above, Continuing Life had no right to demand payment of the funds from the Trustee until the promise to provide lifetime care was fulfilled.

The Commissioner also argued that Continuing Life's method, which required annual adjustments to the amount to be taken into income each year due to changes in life expectancy calculations, was too complex to clearly reflect income. Notably, the method adopted by Congress under I.R.C. § 401(a)(9) to determine annual Required Minimum Distributions from retirement accounts requires the use of an actuarial table for annual recalculations of the amount to be distributed as the retiree ages, which is essentially the same method that Continuing Life used, further undercutting the Commissioner's complexity argument.

Finally, the Tax Court rejected the argument that it should defer to the Commissioner's opinion that Continuing Life's method did not clearly reflect income, concluding that deference was not warranted based on the undisputed facts of the case. Citing *RLC Industries Co. & Subsidiaries v. C.I.R.,*[18] the Tax Court held that Continuing Life's method for recognizing income was employed consistently and clearly reflected its income, and the Commissioner had no authority to impose an alternative method.

The Ninth Circuit Affirms

In the Ninth Circuit, the Commissioner made most of the same arguments but added for the first time that the terms of the Residence Agreement did not reflect the true intentions of the parties and therefore could be ignored. In its opinion affirming the Tax Court decision, the Ninth Circuit noted:

It is undisputed that CLC's accounting method for deferred entrance fees, which CLC has employed consistently, complies with generally accepted accounting principles ("GAAP"). Under the applicable regulations, such an accounting method will ordinarily clearly reflect income. 26 C.F.R. § 1.446- 1(a)(2) ("A method of accounting which reflects the consistent application of [GAAP] in a particular trade or business . . . will ordinarily be regarded as clearly reflecting income . . . .").

After summarily dismissing the Commissioner's arguments, the Ninth Circuit held:

We agree with the tax court that CLC's accounting method for deferred entrance fees satisfies the all-events test. While the schedule in the Residence Agreement sets the fee amount, CLC's right to receive any deferred entrance fee from a resident becomes fixed only once CLC fulfills its statutory and contractual obligation to provide lifetime care to that resident. CLC's provision of lifetime care is thus properly understood as a condition precedent, not a condition subsequent, to its right to receive any deferred entrance fee.

Because CLC's accounting method for deferred entrance fees clearly reflects income and is consistent with regulatory requirements, the Commissioner lacks authority to impose an alternative method he considers to more clearly reflect income. *RLC Indus*, 98 T.C. at 491.

Key Takeaways

Life care contracts are unique in the tax law. The only reported cases appear to be *Norbury* and *Continuing Life*. While it would be difficult for existing entities to change their current method of accounting, new entities and entities acquiring facilities may be able to adopt the same GAAP method if lifetime care is offered and a binding residence agreement closely follows the Continuing Life model as to when deferred fees may be earned. In addition, it may also be important to use the independent trust and trustee model.

The importance of a binding contract is illustrated in an analysis of the impact of I.R.C. § 451(b), which Congress adopted in 2017. This section requires that the all-events test for determining when an item of income must be recognized for tax purposes shall not be treated as met any later than when the item is taken into account as revenue in an applicable financial statement. An applicable financial statement is one that is certified as being prepared in accordance with GAAP and is an audited financial statement of the taxpayer used (a) for credit purposes; (b) for reports to shareholders, partners or other owners; or (c) for any other substantial nontax purpose. Continuing Life met this standard even before Section 451(b) was enacted, yet the Commissioner nonetheless continued to press the case. One possible reason for the Commissioner's position is that Section 451(b) establishes a "not later" standard, rather than a safe harbor standard, leaving the Commissioner free to demand that income be recognized earlier, which was the case here. But for Continuing Life, whose method complies with Section 451(b), the Tax Court found (and the Ninth Circuit agreed) that the binding terms of the Residence Agreement made the Commissioner's demand for earlier recognition of income unsupportable.

About the Author

Fred Weil is a partner and senior member of Hanson Bridgett LLP's Tax Practice and practiced law for more than 54 years. He specializes in areas of taxation and corporate law, including planning and dispute resolution in tax matters, administrative appeals and Tax Court cases for individuals, estates, for-profit entities, and nonprofit entities.

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[1] *Continuing Life Communities Thousand Oaks, LLC v. C.I.R,* No. 22-70225, 2024 WL 2269274 (May 20, 2024) (unpublished).

[2] *Continuing Life Communities Thousand Oaks, LLC v. C.I.R*, T.C. Memo 2022-31.

[3] Cal. Health & Safety Code § 1771(c)(8).

[4] Cal. Health & Safety Code § 1771(c)(9).

[5] Cal. Health & Safety Code §§ 1770-1793 (inclusive).

[6] Cal. Health & Safety Code §§ 1793.5-1793.7.

[7] Cal. Health and Safety Code § 1770(b) (emphasis added).

[8] Interest free loans to Continuing Life are permitted under I.R.C. § 7872(h).

[9] The Tax Cuts and Jobs Act of 2017 added § 451(b), which requires for years commencing in [2018] that the all-events test under § 451(a) shall not be treated as met with respect to an item of income any later than the time when the item is taken into account as revenue in an "applicable financial statement of the taxpayer . . . ." An applicable financial statement includes a financial statement which is certified as being prepared in accordance with GAAP and which is used for a "substantial nontax purpose." While the accounting method used by Continuing Life during the audit period would now be the minimum requirement, that method could still be challenged by the Commissioner if the Commissioner can demonstrate that it does not clearly reflect income.

[10] In the only instance during the audit period where a resident was expelled, no Deferred Entrance Fees were earned by or paid to Continuing Life, following the terms of the Residence Agreement.

[11] *Hallmark Cards v. C.I.R.*, 90 T.C. 26 (1988) [fn], where the risk of loss passed only upon the beginning of a new year, the Tax Court noted that the very strong likelihood that an event will occur that requires the inclusion of an item as income is insufficient under the all-events test as a matter of law. The provision of life care was an essential term of the Residence Agreement.

[12] 9 T.C. 586 (1947).

[13] Curiously, in *Norbury,* unlike the instant case, the Commissioner argued, and the Tax Court agreed, that income under a written agreement for life care of a person where funds were held in escrow was not reportable as income to the recipient until the person had died. The recipient had argued that the amount was income that was reportable in the year that the contract was signed—a year barred by the statute of limitations.

[14] *Highland Farms, Inc. & Subs. v C.I.R.,* 106 T.C. 237 (1996).

[15] *Schlude v. Comm'r*, 372 U.S. 128 (1963).

[16] *American Automobile Ass'n v. United States,* 367 U.S. 687 (1961).

[17] *Automobile Club of Mich. v. Comm'r,* 353 U.S. 180 (1957).

[18] 98 T.C. 457 (1992). In a case involving depletion allowances for harvested timber, the Commissioner attempted to impose an accounting method the Commissioner felt more clearly reflected income than the taxpayer's method. The Tax Court found that the taxpayer's method of accounting clearly reflected income. Therefore, the Tax Court held that the Commissioner "cannot require a taxpayer to change from an accounting method which clearly reflects income because the Commissioner considers an alternate method to more clearly reflect income."