SPECIAL ISSUE

brief

SUMMER 2008

Key Tax Benefits for Seniors Housing Residents

Prepared by

American Seniors Housing Association

HansonBridgett Inspired

Table of Contents

Key Tax Benefits for Seniors Housing Residents

I. TAX BENEFITS IN GENERAL

Many seniors housing residents enjoy tax benefits unavailable in residential rental properties and most other occupancies. The availability of assisted living or nursing care provides tax deduction opportunities with subtle distinctions that may not be known to the average consumer or marketing professional. Unique payment structures, such as entrance fees and entrance fee refunds can complicate the issues significantly. Ownership and life estate structures can add further nuances that are not present in traditional rental arrangements. A clear understanding of the applicable rules is essential when positioning a seniors housing community in the marketplace, training sales and marketing professionals, and communicating with the general public. This is particularly true today as creative financial and service options continue to emerge in seniors housing.

II. MEDICAL EXPENSE DEDUCTIONS

A. Eligibility of Assisted Living and Skilled Nursing Services

The Internal Revenue Code permits a deduction from income tax for expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, the taxpayer's spouse or a dependent, to the extent that such expenses exceed 7.5% of adjusted gross income.[1]

Medical care is defined as "amounts paid for the diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure of the body."[2] Expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illnesses, and specifically nursing services, are covered.[3] The extent to which care at a place other than a hospital constitutes deductible medical care is primarily a question of fact, which depends upon the condition of the individual and the nature of the services received.

Medical care includes skilled nursing and assisted nursing services when rendered in a licensed setting, such as an assisted living facility or skilled nursing facility, where the primary purpose of the resident's presence there is to receive such services. Rulings pertaining to the deductibility of entrance fees and monthly fees in lifetime care facilities

[1] I.R.C.§ 213(a)

[2] I.R.C.§ 213(g)(1)(A)

[3] 26 CFR § 213(e)(1)(ii)

(see below) seem to make it clear that both nursing and assisted living services are potentially eligible for the medical expense deduction.

Where the availability of medical care is the principal reason for person's presence at a facility, and meals and lodging are furnished as a necessary incident of such care, the entire cost of medical care and meals and lodging constitutes an expense for medical care. If the availability of medical care is not a principal reason for the person's presence there, only that part of the cost attributable to medical care is deductible, and meals and lodging are not considered a cost of medical care. IRS regulations specifically mention that if an individual is in a "home for the aged" for personal or family reasons, and not because he or she requires medical or nursing attention, meals and lodging at the home are not considered a cost of medical care. One common situation that probably would not result in medical expense deduction eligibility is where the spouse of a resident who moves to assisted living enters the assisted living facility for the primary purpose of residing with the spouse needing care, and not for the purpose of receiving care himself or herself.

B. The Impact of HIPAA

In 1996, the Internal Revenue Code4 was amended by the Health Insurance Portability and Accountability Act (HIPAA) to specify that deductible medical expenses include "qualified long-term care services." Such services include, among other things, maintenance or personal care services that are required by a "chronically ill individual" pursuant to a plan of care prescribed by a licensed health care practitioner (including physicians, nurses and social workers). A "chronically ill individual" is one whom the health care practitioner has certified as being unable to perform at least two activities of daily living for a period of at least 90 days due to a loss of functional capacity or who requires substantial supervision from threats to health and safety due to severe cognitive impairment.

After HIPAA's adoption, there was debate as to whether HIPAA limited the deductibility of assisted living services to people who are "chronically ill individuals." More likely, however, HIPAA creates a "safe harbor" with specific criteria that would assure deductibility of the expense (supplementing the case-by-case method of the prior law). A principal purpose of HIPAA's long-term care provisions was to establish the deductibility of certain long-term care insurance premiums. HIPAA did not amend or supersede the existing general provisions governing medical deductions, and therefore the pre-HIPAA rulings establishing the deductibility of expenses paid for assisted living and nursing services should still be valid, even where the taxpayer does not meet the "chronically ill individual" criteria.

[4] IRC § 213(d)

C. Fees Paid by Independent Living Residents for Health Benefits

Portions of entrance fees and monthly fees paid by independent living residents of a continuing care retirement community ("CCRC") or other "lifetime care facility"[5] are deductible to the extent that they represent a charge or prepayment for assisted living or skilled nursing care. Numerous IRS rulings establish the deductibility of such charges. A percentage of the monthly fee charged by one life care facility that covered the cost of medical care was deductible to residents in independent living.[6] Portions of both entrance fees and monthly fees charged by a retirement community that offered 10 free days of care and charged 90% of market rates for remaining days of care, were deductible as medical expenses.[7] A percentage of an entrance fee allocable to medical care was found to be deductible, provided that any refunded portions would need to be reported as income.[8] Fees currently paid for future medical care are deductible only in facilities that offer lifetime care.[9]

In addition to hospitalization, nursing care and personal care, such as assistance with bathing, dressing and grooming, have been held to be deductible, whereas fees paid for mere household assistance (e.g., assistance with shopping) are not deductible.[10] Deductible medical expenses include staff costs, medications and supplies, pro rata shares of housekeeping, maintenance, utilities, administrative and marketing costs, interest on indebtedness, real estate taxes, insurance and depreciation of the building.[11] Portions of fees used for the construction of health care facilities are not deductible.[12]

1. Allocation of Charges in General

Little guidance is given in the IRS rulings as to how the charges or costs for providing future care to an independent living resident should be apportioned or applied. Among the considerations to be taken into account by both providers and residents are: 1) whether to calculate the medical portion of charges as a percentage of all fees paid or as a specific dollar amount per resident; 2) whether to apply different percentages for independent living fees than for care facility fees; and 3) whether to apply the deduction to entrance fees, monthly fees, or some combination.

[5] Lifetime care facilities are not defined, but likely would exclude month-to-month, annual or other fixed-term contracts, and would include contracts where the resident's occupancy can be terminated only for cause.

[6] Revenue Ruling 67-185

[7] Private Letter Rulings 8930023 and 8930024

[8] Revenue Ruling 75-302. It is unclear whether a resident may deduct as an expense those portions of a refundable entrance fee that are unequivocally refundable on or after termination of the contract [in contrast with refunds that expire over time or are conditioned upon reoccupancy]. A refundable charge of that kind may be treated as a loan that cannot be considered an expense.

[9] Revenue Ruling 93-72

[10] Revenue Ruling 76-106

[11] Private Letter Ruling 8630005

[12] Revenue Ruling 76-481

2. Departmental Cost Approach

Historically, as authorized by numerous IRS rulings, many CCRCs have computed the cost of future care as a percentage of the entrance fees and monthly fees. To calculate the percentage, the CCRC divides the cost of operating the assisted living and nursing departments by the total operating costs for the CCRC. It is not unusual to see 30% or more of a CCRC's total operating expense attributed to the provision of care. The result is that a resident may deduct a fixed percentage [e.g., 30%] of all fees paid to the CCRC as medical expenses. Under this method, if the resident chooses to take a medical expense deduction for a portion of fees paid while in independent living, he or she could not also deduct 100% of the monthly fees paid while in assisted living or nursing. Also, by spreading the medical expenses over all the fees paid to the CCRC, it may be more difficult for the resident to exceed the annual 7.5% of adjusted gross income threshold needed for the expense to be deductible [see below].

3. Subsidy Approach

An alternate approach for allocating deductible medical expenses is the "subsidy" approach, which, in some CCRCs, may allow the resident to deduct 100% of fees paid while in assisted living and nursing, plus an amount that represents the extent to which entrance fees [and possibly independent living monthly fees] subsidize the cost of operating the care facilities.

In a typical "Type A" CCRC, there is no substantial increase in monthly fees when a resident moves from independent living to assisted living or skilled nursing. Assisted living and skilled nursing operations are subsidized by revenues from entrance fees, independent living monthly fees, or both. A similar approach may be used by "Type B" CCRCs, where a limited number of prepaid care days, or a discounted rate for care, is offered. To the extent entrance fees or independent living monthly fees are used to subsidize assisted living and skilled nursing operations, they should be deductible as prepaid medical expenses.

One way to calculate the prepaid medical expense is to divide the dollar amount of the annual subsidy needed to run the assisted living and skilled nursing departments by the number of independent living residents and multiply that number by the average life expectancy of independent living residents.

4. Percentage versus Per Capita

The results of either the departmental cost or subsidy analysis can be expressed alternatively as a percentage of fees paid by residents or as a specific per capita dollar amount for each resident. Although IRS rulings permit a percentage approach, some IRS representatives have expressed in informal discussions that it does not make sense for prepaid medical expenses to vary based upon the size of an entrance fee or monthly fee, which often depends upon the size of the resident's apartment. On the other hand, it can be argued that the per capita cost of medical services is irrelevant, and that if charges paid by residents vary widely for the same level of access to care, the full charges should be deductible.

5. Allocation of Expenses to Different Fees

How the resident allocates the prepaid medical expense amount among entrance fees, independent living monthly fees, or both is yet another issue. Because medical expense deductions can be taken only to the extent they exceed 7.5 percent of the taxpayer's adjusted gross income in any given year, a resident can maximize the deductible amount over 7.5% by taking entire deduction in year entrance fee is paid, rather than every year via monthly fees.

6. The Baker Case

Baker v. Internal Revenue Service was the first U.S. Tax Court case on CCRC medical deductions. The only issue there was how to apply the deduction to independent living monthly fees.

The Court adopted a formula that divided the costs of operating the assisted living and nursing facilities by the total cost of operating the entire community and then applying that percentage to the weighted average monthly fee for independent living residents. The Court rejected the IRS's position that medical deductions should be based upon an actuarial estimation of residents' health facility utilization levels.

The Court decided that the percentage of operating costs devoted to medical services should be applied to the average monthly fee, rather than to each individual's actual monthly fee. This is consistent with the idea that the deductible medical expense should be allocated on per capita basis and not vary because of differences in apartment size or similar irrelevant factors affecting the amount of resident fees.

Several unanswered questions are left by the *Baker* decision. The Court did not discuss the extent to which medical deductions may be taken for entrance fees or for monthly fees while the resident is in assisted living or for the daily skilled nursing charge. If a resident applies a medical expense percentage to the independent living monthly fee, should he or she apply the same percentage to entrance fees and to out-of-pocket fees paid while residing in assisted living or skilled nursing? To take any higher amount would seem to constitute excessive recognition of medical expenses or "double-dipping."

7. Reconciling the Methodologies

The percentage of cost methodology is arguably less desirable compared to the subsidy methodology. Under the subsidy model, a resident may take a significant deduction by attributing the entire prepaid medical expense (subsidy amount) to the entrance fee, thus needing to exceed the 7.5% threshold only once during his or her independent living years. When in the assisted living or nursing facility, a resident using the subsidy method then would be able to deduct 100% of his or her out-of-pocket fees for assisted living and nursing care.

Under the *Baker* case, a resident would need to deduct the 7.5% each year before being able to recognize medical expenses for independent living monthly fees. While in assisted living or nursing, the resident would be limited to the same percentage deducted while he or she was in independent living.

Depending upon the individual's financial and tax circumstances, it may be more desirable for the resident to have higher tax deductions while in assisted living or nursing, particularly if his or her monthly expenses have increased as a result of a transfer to the care facility.

8. Role of CCRC Providers

Ultimately, all the CCRC can and should do is to report its costs to residents and allow them to claim medical deductions as they see fit, in consultation with their personal tax advisors. It may be useful for CCRCs to report both the subsidy amount, if any, that is not covered by periodic fees paid by residents in the care facilities, as well as the percentage of overall costs represented by the operations of those facilities.

Residents and their tax advisors can then turn to outside resources, such as trade association publications, to gain a better understanding of how to apply the CCRC's information in a way that best suits their clients' individual tax circumstances. Under no circumstance should CCRC management give tax advice to residents.

III. IMPUTED INTEREST

A. The Historical Problem

Amendments to the Internal Revenue Code in 1984 establish rules concerning "below-market loans," in which a lender charges less than market rate interest and in return receives some other form of market-value consideration, such as services.[13] The lender is taxed as if interest income at the "applicable federal rate" has been received from the borrower, even though no actual payment of interest had been made.

Refundable entrance fees paid to continuing care facilities generally have been considered to be subject to the below-market loan or "imputed interest" rules, except that loans made prior to June 6, 1984 were not subject to the provisions, and payments where the resident's right to a refund amortized to zero within eight years of payment were also considered to be exempt.

[13] Internal Revenue Code §§ 7872, et seq.

B. Loans to Qualified Continuing Care Facilities

1. Before 2006

From 1985 to 2006, loans of up to $90,000 per resident-lender made to "qualified continuing care facilities" were exempted from the imputed interest rules, subject to the following:

(a) the lender must have attained age 65 before the close of the year in which the loan is made.

(b) the $90,000 figure was inflated each year in accordance with changes in the Consumer Price Index, reaching $163,300 for 2006.

(c) facilities had to be designed to provide services under continuing care contracts, and substantially all of the residents had to be covered by continuing care contracts.

(d) substantially all facilities used to provide services under a continuing care contract were required to be owned or operated by the borrower.

(e) a continuing care contract was defined as one in which (i) the individual or individual's spouse may use the qualified continuing care facility for life, (ii) the resident first resides in a separate independent living unit with dining and service facilities outside the unit, and then will be provided personal care and skilled nursing care as the person's health requires, and (iii) no additional substantial payment14 is required if the resident requires increased personal care or skilled nursing care.

Ironically, continuing care facilities that did not meet the "qualified" definition enjoyed a moratorium on enforcement of the imputed interest rules pending adoption of regulations by the IRS. As of 2006, regulations had not been adopted.

2. 2006 CCRC Amendments

In 2006, Congress greatly broadened the definition of a qualified continuing care facility so that most refundable entrance fee arrangements at most CCRCs are exempt from the imputed rules.

Qualified facilities are now required to have: (a) a minimum 62 year age of admission, (b) a contract for the lifetime of the resident, and (c) the availability of assisted living or nursing facilities. The facility is not required to limit fee increases when a resident moves to a higher level of care, and there is *no dollar limit* on the amount of the loan

[14] A 5% increase in cost when moving from independent living to assisted living; and a 25% increase when moving from assisted living to skilled nursing was found not to be substantial: Priv.Ltr.Rul. 9252015.

covered by the exemption. And, the borrower is not required to own or operate substantially all the CCRC's facilities.

The changes are effective after December 31, 2005 for contracts entered into before or after that date. The IRS has not yet adopted regulations interpreting the 2006 amendments.

IV. HOME OWNERSHIP

A. Deductible Expenses

Owners of fee simple residences, condominiums, cooperatives, and life estates[15] are entitled to a tax deduction for mortgage interest and property taxes where the property is their "principal residence." These privileges are not available to rental or entrance fee arrangements.

B. Capital Gain Exclusion

Upon resale of their property, homeowners are entitled to a capital gain exclusion of $250,000 for an individual and $500,000 for joint return filers.[16] Taxpayers must own and use the property as principal residence for at least two of the prior five years to be eligible. Complications may arise in retirement communities where service fees, such as a lump sum club membership charge, are commingled with real estate purchase prices. The allocation of charges between real estate and non-real estate may also have implications for the developer/operator when determining what revenues to offset against its tax basis in the real property. In service-intensive for-sale properties, a balance between the tax interests of the seller and buyer must be carefully considered.

V. CONCLUSION

As developers and operators of seniors housing communities offer new and more creative financial and service options, the ways in which tax laws apply to residents are likely to become more complicated. Because of the nuances involved in applying the proper tax deductions for residents, it is absolutely essential that developers, marketers, and operators be sensitive to these complexities and ensure that representations made to the public are carefully and appropriately communicated.

[15] See I.R.C. §§163, 164; Revenue Ruling 84-43

[16] I.R.C. §121

American Seniors Housing Association

5100 Wisconsin Avenue, NW
Suite 307
Washington, DC 20016
(202) 237.0900
FAX (202) 237.1616
www.seniorshousing.org

ABOUT THE AUTHOR

Hanson Bridgett LLP is a 130-lawyer San Francisco law firm with a specialty practice in seniors housing and long-term care, with supportive practices in business, real estate, labor and employment, employee benefits, litigation, health care and other disciplines.

Paul has represented hundreds of seniors housing and care companies, facilities and investors since 1975 and practices exclusively in the area. He is the author of Seniors' Housing and Care Facilties: Development, Business and Operations, 3rd edition (Urban Land Institute, 1998) — a 600-page volume with over 1,000 additional pages of business forms on CD-ROM. Paul has been on the Executive Board of the American Seniors Housing Association since 1995, and serves as its legal counseL. He is former chair of the Legal Committee of the American Association of Homes and Services for the Aging and the American Bar Association's Committee on Housing for the Elderly.