GOLD AT THE END OF THE RAINBOW: MEDICAL EXPENSES AND BELOW-MARKET-RATE LOANS IN CONTINUING CARE RETIREMENT COMMUNITIES

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ABSTRACT

Residents of continuing care retirement communities (CCRCs) may take a medical expense deduction for a significant portion of both their entrance fee and monthly fees. For the entrance fee, this usually results in a large medical expense deduction in the year the fee is paid. In the first part of the article, we track the history of the CCRC medical expense deduction and examine its tax effects on residents of independent living, assisted living, and nursing care units.

Many CCRCs agree to refund a portion or all of the entrance fee without interest when the resident moves out or dies. In the second part of the article, we examine two potentially significant tax effects of a guaranteed refund. First, the refund may be subject to the below-market-rate loan rules and as such may produce imputed interest income for the resident and interest expense for the CCRC. Second, the refund may reduce the deductible amount of the medical portion of the entrance fee.

Finally, CCRCs are responsible for accurately informing their residents as to the deductible medical portion of the fees. The computational methods used in practice - the expense category method and the actuarial method - are often inconsistently or illogically applied, resulting in advice that shortchanges the residents and is open to IRS challenge. In the third part of the article, we critique the two methods and recommend that CCRCs use the expense category method to determine the deductible portion of the monthly fees and the actuarial method for entrance fees.

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GOLD AT THE END OF THE RAINBOW: MEDICAL EXPENSES AND BELOW-MARKET-RATE LOANS IN CONTINUING CARE RETIREMENT COMMUNITIES

I. Introduction

A. Purpose

Residents of continuing care retirement communities (CCRCs) or their children, if the residents are the children's dependents,[1] face significant tax consequences associated with the fees they pay to a CCRC. On the positive side, they usually can take a large tax deduction for the medical expense portion of their entrance fee[2] and may also deduct the medical portion of their monthly fees. Negative consequences may occur, however, if the CCRC is obliged to refund some or all of the entrance fee when a resident vacates or dies. The refundable portion of the fee may be treated as a below-market-rate loan in which case residents may have to report imputed interest income, and the CCRC, imputed interest expense, on the refundable portion of the entrance fee.[3] Residents also may have taxable income on the refund if they took a medical expense deduction on the entire original fee. This article addresses these consequences and analyzes the methods CCRCs use in estimating the portions of the entrance and monthly fees allocable to medical care.

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[1] Throughout this article, references to the residents generally apply also to the residents' children if they are paying their parents' medical bills including CCRC fees and are claiming their parents as dependents. *See* I.R.C. §§ 213(a), 152(a)(4).

In fact, the dependency rules for deducting parents' medical costs are less stringent than the rules for claiming them as exemptions. The I.R.C. § 151 income test does not apply for medical expense deduction purposes. In other words, if a child cannot claim a dependency exemption for their parent(s) solely because they fail the income test, the parent(s) will still qualify as dependents for the purpose of deducting the medical expenses paid by the child on their behalf.

[2] Entrance fees are also known as entry fees, advance fees, or founder's fees. Fifteen percent of CCRCs are rental only and do not charge entrance fees. American Association of Homes and Services for the Aging, *The Consumers' Directory of Continuing Care Retirement Communities*, *1994/1995 edition* (1994).

[3] We provide examples of these computations in section III.B.4. *infra*.

In many cases, the tax impact of moving into a CCRC may be very large, resulting in a medical expense deduction of $20,000 or more for the entrance fee and $3,000 or more annually for the monthly fees.[4] Residents in assisted living units (ALUs) generally should be able to deduct 100% of their monthly fees. Nursing care residents also may deduct 100% of their monthly fees.

The IRS has provided little guidance regarding the mechanics of computing the deduction, the acceptability of the various rationales used by CCRCs in computing the medical expense percentage of their residents' fees, or the tax effects on residents or their estates of an entrance fee refund. Furthermore, there is little consistency among CCRCs in advising their residents as to what is deductible or in their methods of computing the percentage of fees allocable to medical costs.

The need for consistent and proper treatment of the CCRC medical expense deduction is growing in importance. Since the 1970's, the number of CCRCs has increased dramatically. In 1994 there were over 350,000 residents in nearly 1,200 CCRCs.[5] This number is growing steadily and will accelerate after 2010 as the baby boomers reach retirement age.

To our knowledge, four articles to date have addressed the tax deductibility of CCRC fees. The first focused on nursing home residents,[6] the second misinformed the readers,[7] the third devoted only one paragraph to the issue,[8] and the fourth discussed the

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[4] Based on our survey of CCRCs around the country, entrance fees generally range from $50,000-$200,000, monthly fees range from $600-$2,500, and the portions attributable to medical costs range from 10%-40%. Entrance fees for couples may exceed $300,000.

[5] David W. Scruggs, *The Future of Continuing Care Retirement Communities, Dare to Discover Series* 25 (1995).

[6] A. Mark Christopher, *Ways to Reduce Tax Burdens of Nursing Home Residents*, 70 J. Tax'n 364 (1989).

[7] Gary Friedman, *Tax Planning for Continuing Care Retirement Community Residents*, 5 Prac. Tax Law. 89 (1991).

effects of the Health Insurance Portability and Accountability Act of 1996[9] on deductibility of long-term care expenses and insurance.[10] The second article stated, "[i]n counseling on the tax deductibility . . . of CCRC costs, you must first establish whether the principal reason for entry into the CCRC is the availability of medical and nursing care . . . ."[11] This is wrong. As we discuss in section II.B.2., non-medical reasons for entering a CCRC will not prevent the deductibility of the medical expense portion of the fees.[12]

Our objectives are: (1) to clarify the tax deduction opportunities for CCRC residents, (2) to alert both the residents and CCRC administrators as to the potential tax effects of refundable entrance fees, and (3) to give CCRC administrators direction on allocating the medical expense fee portion properly so as to maximize their residents' potential tax savings.

Regarding entrance fee refunds, we examine three issues: (1) whether the section 7872[13] below-market-rate loan rules will trigger imputed interest on the refundable portion of entrance fees, (2) whether an anticipated entrance fee refund must be subtracted from the entrance fee in calculating the medical expense deduction, and (3)

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[8] Sarah C. Harlan, *Housing for the Elderly: Federal Income Tax Concerns*, 5 Exempt Org. Tax Rev. 39 (1992). The article principally addresses tax issues facing taxable and tax-exempt CCRC providers.

[9] Pub. L. No. 104-191, 110 Stat. 1936. For further discussion of the Act which applies to tax years beginning after December 31, 1996 with respect to the long-term care provisions, see *infra* notes 72 - 81 and accompanying text. *See also infra* section II.B.3.b.

[10] A. Mark Christopher, *New Law Provides Ways to Reduce Tax Burdens Relating to Long-Term Care*, 86 J. Tax'n 20 (1997). For further discussion of the effects of the Health Insurance Portability and Accountability Act of 1996 on CCRCs and their residents, see notes 72 - 81 and accompanying text as well as section II.B.3.b. *infra*.

[11] Friedman*, supra* note , at 93.

[12] For nursing care residents, all of the fees are deductible if entry into the nursing care unit of the CCRC was for medical rather than personal or family reasons. *Counts v. Commissioner*, 42 T.C. 755 (1964). For further discussion, see section II.C *infra*.

[13] Statutory references are to the Internal Revenue Code of 1986, as amended (the Code), and the Regulations promulgated thereunder, except as otherwise noted.

whether the residents, their estates, or their heirs will have to recognize income in the year the refund is received to the extent of the previously deducted medical expenses attributed to the refund.

The following example of a CCRC resident related to one of the authors illustrates most of the issues involved as well as the magnitude of the tax savings available in properly taking advantage of the deduction.

B. An Example

Mrs. W, age 80, paid a $103,500 entrance fee to a CCRC late in the summer of 1992 for a two-bedroom independent living unit; she also began paying a $1,125 monthly fee prorated from September 24, 1992. According to the basic contract with the CCRC, the refundable portion of the entrance fee, which would be paid to her if she moved out prior to death or otherwise to her estate, decreased two percent for each month of residence until reaching a 50% floor. The contract also offered a nursing care option under which she agreed to forfeit an additional 12% ($12,420) of her entrance fee in exchange for a guarantee to receive nursing care at no additional charge beyond her regular monthly fee. In other words, her refundable amount would decrease to 38% instead of 50%.

Fortunately, Mrs. W does not have to contend with the section 7872 below-market-rate loan rules with respect to the guaranteed refundable portion of her entrance fee. Although the non-interest-bearing refund would qualify as a below-market-rate loan

under section 7872, it is well below the section 7872(g) exemption amount[14] for residents of qualified CCRCs, as discussed in section III.B.

In February 1993, she received a letter from the CCRC stating that 20% of her fees paid in 1992 were deductible medical expenses; however, the deductible portion of the non-refundable half of the entrance fee had to be amortized over 480 months. The letter further advised that, if the nursing care option had been selected, the 12% forfeitable portion of the entrance fee refund would not be deductible until the resident vacated. Relying on the CCRC's statement, Mrs. W's accountant determined that she had $813 in CCRC-related medical expenses for 1992 -- $86 for the amortized portion of half of the entrance fee and $727 for the monthly fees she paid to the CCRC in 1992.[15] She did not benefit from the expenses, however, because she did not have enough medical expenses to exceed 7½% of her adjusted gross income.

The CCRC's letter erred in three ways, the first of which involved the amortization of the entrance fee. Despite the unlikely possibility that any of the residents would live another 40 years, the CCRC's administrator maintained that the 480-month amortization period was correct because, according to their Big-5 accounting firm, the residents' entrance fees were not paid to the CCRC directly but rather to a trust that was liable for the 40-year mortgage on the facilities. As we elaborate in section II.B.2., a deduction based on the entrance fee must be taken in the year the fee is paid, notwithstanding any serpentine legal structure that exists between a resident's payment of

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[14] The $90,000 exemption is indexed for inflation and was $114,100 in 1992 (*see* Rev. Rul. 92-7, 1992-1 C.B. 438) when she paid her entrance fee. Mrs. W's guaranteed refund of $39,330 ($103,500 x 38%) is exempt. Of note, we believe the applicable loan amount for exemption purposes is the discounted present value, *see infra* section III.B.3., because it is considered a term loan, *see infra* section III.B.2.

[15] Calculated as follows: Entrance fee deduction = ([($103,500 x [1 - .38 refundable portion - .12 nursing care option]) / 480 months] x 4 months x 20% medical expense portion); deduction for monthly fees = ($1,125 x 3.23 months x 20% medical expense portion).

the entrance fee and the CCRC's obligation to provide lifecare. Furthermore, since we determine in section III.B.2. that a refund is a term loan under section 7872 and as such is not deductible, the medical expense deduction should be based on the entrance fee less the discounted present value of the 50% refundable amount.

Second, the letter stated that the portion of the entrance fee refund allocated to the nursing care option, which in Mrs. W's case amounted to $12,420,[16] would not be deductible until the year that residency is terminated. In fact, it is deductible in the year paid as we point out in section II.E.

Third, the letter dictated that 20% of both her entrance fee and monthly fees were deductible as medical expenses. The burden of proof, however, is on the taxpayer to show that the claimed medical deduction is the proper amount.[17] Whether the 20% figure is correct is a question of fact. Depending on the cost allocation method used, reasonable minds will differ as to the correct percentage. Section IV. discusses the propriety of different cost allocation methods used by CCRCs. Because the burden of proof is on Mrs. W, we acquired the CCRC's 1992 revenue and expense statement from which we determined that 14.72% of the CCRC's expenses were medically related. This percentage was applied to the monthly fees paid in 1992.

For the entrance fee, we estimated that 25.48% was for medical expenses over her actuarial life span at the CCRC. Based on the CCRC's revenue and expense statements, the medical expense percentage rose steadily from 14.72% in 1992 to 19.99% in 1995.

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[16] Calculated as follows: ($103,500 entrance fee) x (12% reduction in the entrance fee refund percentage).

[17] *See New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1933) and Rule 142(a), 93 T.C. 950 (1989). Congress is reviewing the burden of proof issue. The House recently passed the Internal Revenue Service Restructuring and Reform Act of 1997, H.R. 2676, 105th Cong., 1st Sess. (1997)(enacted). Section 301 of the bill shifts the burden of proof to the IRS for cases which come before the Tax Court. To be eligible for the benefits of the shift, taxpayers must fully cooperate with reasonable requests by the IRS for documents, information, and access to witnesses. Corporations, trusts, and partnerships having net worths exceeding $7 million are ineligible.

The burden of proof remains with the taxpayer during the IRS auditing process.

We projected the CCRC's medical expense percentage trend across Mrs. W's actuarial life span, estimating a 25.48% average percentage. We then multiplied this percentage by the net entrance fee, *i.e.*, the $103,500 fee, less the 38% guaranteed refund discounted over her actuarial life and less the 12% nursing care option. The rationale for using the net entrance fee rather than the full entrance fee is discussed in section III.C.3.

On our advice, she filed an amendment to claim a $30,988 medical expense deduction in 1992: $18,033 for the entrance fee, $12,420 for the nursing care option, and $535 for the monthly fees.[18] She received a $5,339 federal income tax refund plus interest.[19]

C. CCRC Residential and Medical Arrangements

Most CCRCs offer three levels of residence: (1) independent living units (ILUs) which are similar to apartment living except that nursing assistance is usually available through an emergency pull-cord call system, (2) assisted living units (ALUs), also called personal care units, in which the residents are assisted with tasks such as dressing and eating, and (3) nursing care units providing 24-hour care. CCRCs generally provide a variety of additional services at all levels of residency: daily meal service, weekly laundry and maid services, electronic monitoring of rooms, local transportation, athletic facilities, and social activities. To enter a CCRC, residents typically must be ambulatory

[18] Calculated as follows: Entrance fee deduction = ($103,500 x [1 - .196213 discounted present value of the 38% refundable portion, discounted over her actuarial life of 9.5 years at the applicable federal long-term rate of 7.08% compounded semiannually - .12 nursing care option] x 25.48% medical expense portion); nursing care portion of the entrance fee = ($103,500 x .12); and deductible monthly fees = ($1,125 x 3.23 months x 14.72% medical expense portion). See Reg. § 1.72-9 (as amended in 1995), *Table V*, for the actuarial life, and Rev. Rul. 92-67, 1992-2 C.B. 208.

[19] The refund would have been higher had she had enough taxable income to receive the full tax benefit from the deduction. The state income tax effect was not an issue since her state has no personal income tax.

at the time they sign the residence contract, and only after residing in an ILU may they transfer to an ALU or nursing care facility.

CCRCs offer two occupancy arrangements: proprietary or non-proprietary. Under a proprietary agreement, residents own their units, often in a condominium or cooperative arrangement. The cost of purchase is paid in lieu of an entrance fee. The resident or their estate has the responsibility of selling the unit, and the CCRC may charge an ownership transfer fee. Until mid-1997 this type of arrangement was attractive because, unlike non-proprietary arrangements, it qualified for tax deferral rollover treatment when a personal residence was sold as part of the process.[20] For that reason, proprietary ownership arrangements grew in popularity although only 6% of CCRCs presently offer them.[21] Now that sellers of personal residences can exclude up to $250,000 ($500,000 if married, filing jointly) of the gains realized, there are few prospective residents who will have a tax incentive to seek proprietary ownership.[22]

Non-proprietary agreements requiring payment of an entrance fee are the most common type of arrangement. The resident pays a monthly fee and may pay an entrance fee, which may be refundable all or in part. Non-proprietary agreements without an entrance fee are essentially rentals.

CCRCs typically offer one of three nursing-care arrangements:

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[20] The I.R.C. § 1034 rollover deferral of gain provision was repealed effective May 7, 1997, but taxpayers may opt to apply it through August 5, 1997 or afterward if a contract was in effect or a replacement residence was acquired before August 6, 1997. Although a non-proprietary entrance fee did not qualify for rollover relief, residents could still avail themselves of the 55-years-of-age-or-older $125,000, one-time exclusion of gain on the sale or exchange of their personal residence under the pre-May 7, 1997 version of I.R.C. § 121.

[21] *See* Scruggs, *supra* note , at 21-22.

[22] *See* § 312 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, 836 (amending I.R.C. § 121). The main qualifying provision requires that the property sold must have been owned for at least five years preceding sale and used as the principal residence for at least two years by the taxpayer.

Contract Type	Description
Extensive	The monthly fees cover all of the residents' expenses whether they reside in ILUs, ALUs, or nursing care units.
Modified	Although the monthly fees cover all of the residents' ILU expenses, they cover only a specified period of ALU and nursing care, usually 10 - 90 days, without additional cost.
Fee-for-service	The monthly fees cover only the residents' ILU expenses. ALU and nursing care are provided at market rates.

Normally only CCRCs requiring an entrance fee offer the extensive and modified contractual arrangements. Depending on the CCRC, fee-for-service nursing care is available under both proprietary and non-proprietary agreements, whether or not an entrance fee is required. The difference in fees between the three contract types is considerable. Using a survey conducted in 1988 by the American Association of Homes and Services for the Aging (AAHSA) and Ernst & Young, which we adjusted to 1997 dollars, Frank A. Sloan and his colleagues found that CCRCs with extensive, modified, or fee-for-service contracts charged, on average, $230,000, $167,000, and $138,000 respectively in entrance and monthly fees for the first ten years of residency.[23] After adjusting for non-medical factors affecting the fees in the study, they found that the differential between extensive and fee-for-service CCRCs (adjusted to 1997 dollars)

[23] Frank A. Sloan et al., *Continuing Care Retirement Communities: Prospects for Reducing Institutional Long-Term Care*, 20 J. of Health Pol., Pol'y & L. 75, 90 (1995).

decreased from $92,000 to $53,000, and between modified and fee-for-service CCRCs, from $29,000 to $24,000.[24] These differentials indicate the magnitude of ALU and nursing care costs factored into CCRCs' fee schedules.

According to a survey by the AAHSA, 38% of the responding CCRCs offered extensive agreements, 34% offered modified agreements, 41% offered fee-for-service agreements, 15% offered rental contracts, and 6% offered equity ownership.[25] (The total exceeds 100% because some CCRCs offer more than one option.) Although 77% of more recently built tax-exempt CCRCs offer extensive agreements,[26] the direction of the industry with respect to contract type is not as clear when also considering for-profit CCRCs.[27] Each of these contractual arrangements has somewhat different tax implications, as discussed below.

D. Organization

The remainder of the article is arranged as follows:

Section II. tracks the history and discusses the tax deductibility of the medical expense portion of entrance and monthly fees.

Section III. investigates the application of section 7872 below-market-rate loan rules to entrance fee refunds and addresses the impact of entrance fee refunds on deductibility.

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[24] *Id.*

[25] *See* Scruggs, *supra* note , at 28.

[26] Herbert J. Sims & Co., Inc. et al., *Emerging Continuing Care Retirement Communities: An Analysis of Key Statistics* 13 (1994). The survey included 51 CCRCs that completed tax-exempt bond financings between 1988 and 1993.

[27] Interview with Kathleen Harris, A.V. Powell & Associates, Inc., in Chesterfield, Missouri (Jan. 21,1998).

Section IV. analyzes and makes recommendations regarding the methods used by CCRC administrators for determining the medical care portion of their residents' fees.

Section V. summarizes the findings and recommends strategies for CCRC residents and administrators in treating the medical expense issue.

II. Deductibility of CCRC Fees as Medical Expenses

A. Summary

Deductibility of the medical expense portion of CCRC monthly and entrance fees is well-established under both case law and IRS administrative pronouncements. For ILU residents, monthly fees are deductible only to the extent of the medical expense portion. For nursing care residents and most ALU residents, the entire monthly fee is deductible even though medical care is simply *a*, rather than *the*, principal reason for their being in ALU or nursing care units. As for entrance fees, the Service allows deductibility of the medical care portion in the year the fee is paid even though the medical services are performed in the future.[28]

Due to the lack of literature addressing CCRC-related medical expense deductions, we discuss the historical development in the next section. Included in section B. are discussions of recent IRS action on deductibility (section B.3.) and of the premise that the medical expense portion of CCRC fees is in fact medical insurance (section B.4.).

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[28] The entire entrance fee would also be deductible in the unlikely event that a CCRC admitted a new resident directly into its nursing care unit. The same would be true for new residents directly admitted into ALUs if they qualify for full deductibility of their monthly fees as elaborated in section II.B.3.b. Nonetheless, CCRCs rarely accept non-ambulatory new residents.

Section C. covers full deductibility of monthly fees for ALU and nursing unit residents. Section D. recommends how to deduct fees designated for building CCRC medical facilities, and section E. discusses the full deductibility of nursing care upgrade fees.

B. Historical Development

1. Early rulings. Medical expenses and medical insurance costs have long been deductible expenses under section 213 and its predecessor, section 23(x) of the Internal Revenue Code of 1939. In a General Counsel Memorandum (G.C.M.) issued in 1966,[29] the IRS first acknowledged deductibility of the medical portion of an entrance fee as a medical expense. The IRS next ruled in 1967 on the monthly fee issue, effectively stating that a CCRC's experience is an acceptable basis for determining the medical allocation.[30] Since "[t]he taxpayers proved that on the basis of the [CCRC's] experience, . . . a specific portion of the fee covers the costs of providing medical care for them,"[31] they were permitted a medical deduction for 30% of the CCRC's monthly fee. The IRS cited this ruling favorably the following year in terms of the monthly fee issue, but denied a deduction for the medical portion of an entrance fee because it was a capital expenditure used solely for building an infirmary.[32]

In 1971, the IRS's General Counsel released a memorandum[33] discussing two proposed revenue rulings that affirmed and amplified the 1966 G.C.M.[34] in allowing

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[29] G.C.M. 33,259 (June 10, 1966).

[30] Rev. Rul. 67-185, 1967-1 C.B. 70. I.R.C. § 213 provides the authority for deducting medical expenses.

[31] Rev. Rul. 67-185, 1967-1 C.B. 70.

[32] Rev. Rul. 68-525, 1968-2 C.B. 112. I.R.C. § 263 blocks deduction of capital expenditures as medical expenses except under certain circumstances. *See* discussion *infra* section II.D.

[33] G.C.M. 34,561 (July 26, 1971). The memorandum analyzed two proposed revenue rulings, one of which dealt with a retirement community (later issued as Rev. Rul. 75-302, 1975-2 C.B. 86) and the other with a private institution for the severely handicapped (later issued as Rev. Rul. 75-303, 1975-2 C.B. 87).

deduction of the medical expense portion of an entrance fee. In the portion of the G.C.M. later issued as Revenue Ruling 75-302,[35] the Service determined that a resident who paid an entrance fee in exchange for the CCRC's guarantee of lifecare could deduct 30% of the fee in the year paid even though “the medical services were not to be performed until a future time, if it all.”[36] The IRS concluded that the CCRC “demonstrated,” based on its prior experience, that an average of 30% of its lifecare budget was medically related.[37]

This G.C.M. and subsequent rulings[38] raised two new issues, the first of which involved a refundable entrance fee. If residents received a partial refund of their entrance fee as a result of terminating residence, the previously deducted medical expense attributable to the refunded amount should be included in the residents' gross income in the year received.[39] We examine the refund issue in section III.C. The second issue was whether the medical care portion of an entrance fee could be characterized as a payment for medical insurance. Although the IRS initially thought that it could be so characterized, the Service subsequently reversed itself and rejected the insurance rationale when it finally issued the rulings in 1975.[40] We disagree with the IRS’s reversal and discuss this further in section II.B.4.

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[34] G.C.M. 33,259 (June 10, 1966).

[35] 1975-2 C.B. 86.

[36] G.C.M. 34,561 (July 26, 1971), at 18. *See supra* text accompanying note 33. The wording remained virtually the same in Rev. Rul. 75-302, 1975-2 C.B. 86.

[37] G.C.M. 34,561 (July 26, 1971), at 15.

[38] Rev. Rul. 75-303, 1975-2 C.B. 87; Rev. Rul. 75-302, 1975-2 C.B. 86.

[39] *See* G.C.M. 34,561 (July 26, 1971); Rev. Rul. 75-303, 1975-2 C.B. 87; Rev. Rul. 75-302, 1975-2 C.B. 86.

[40] Rev. Rul. 75-303, 1975-2 C.B. 87; Rev. Rul. 75-302, 1975-2 C.B. 86.

In 1976, Revenue Ruling 76-481[41] expanded on Revenue Ruling 75-302[42] by allowing use of the long-term operating experience of a comparable CCRC for calculating the medical care percentage of both the entrance fee and monthly fees.[43] The CCRC addressed in Revenue Ruling 76-481 had not been in operation long enough to determine from its financial experience what portion of the fees was allocable to the medical care of the residents. Per a letter sent by the CCRC to its residents, 15% of the monthly fee and 10% of the entrance fee would be used to fulfill its medical care obligations. Since then, private letter rulings have addressed CCRCs reporting medical costs as high as 45%[44] and 48%[45] of total expenses, but the Service expressed no opinion on the propriety of those percentages. Revenue Ruling 76-481 also stated that an additional 5% of the CCRC's entrance fee would be used to construct health facilities for the residents. In accordance with Revenue Ruling 68-525,[46] the ruling denied a deduction for the health facility portion of the entrance fee.

2. Deducting future medical costs in the year paid - the rationale. Treasury Regulation section 1.213-1(a)(1) requires that a cash basis taxpayer deduct medical expenses in the year paid. Whether the medical portion of an entrance fee may be deducted in the year paid depends on whether there is a legal obligation to pay in advance for the medical care in exchange for the care giver's contractual obligation to provide the

[41] 1976-2 C.B. 82. In the ruling, the Service allowed deductions for the medical expense portion of the monthly fees as per Rev. Rul. 67-185, 1967-1 C.B. 70, and the entire medical expense portion of the entrance fee in the year paid as per Rev. Rul. 75-302, 1975-2 C.B. 86 and Rev. Rul. 75-303, 1975-2 C.B. 87.

[42] 1975-2 C.B. 86.

[43] For further discussion of the methods deemed acceptable by the IRS for determining the portion of entrance and monthly fees allocable to medical care, see *infra* section IV.

[44] P.L.R. 80-09-030 (Nov. 29, 1979).

[45] P.L.R. 80-11-123 (Nov. 29, 1979).

[46] 1968-2 C.B. 112.

care. In *Bassett v. Commissioner*, the Tax Court held that an advance payment for medical care was not deductible in the year paid because the care giver did not require the advance payment as a condition for providing the future care.[47] Concurring in *Rose v. Commissioner*, the court added, "[i]t has long been held that expenses are not incurred in the taxable year unless a legal obligation to pay them has arisen."[48] Therefore, if the contract obligates the CCRC to provide the resident with future medical care, the medical expense portion of the entrance fee is deductible in the year paid.

Although the IRS followed the court's "legal obligation to pay" reasoning through the 1970's in allowing deduction of medical expenses allocable to CCRC entrance fees,[49] it apparently decided to contest it in a 1983 case, *Estate of Smith v. Commissioner*.[50] Smith had taken a deduction for the medical expense portion of an entrance fee that he had paid for his dependent parents. Part of the deduction was for future medical care. In allowing a deduction for the 7% medical portion of the entrance fee, the court stated, "[t]he obligation to pay this fee was incurred at the time the residency agreement was entered into, in return for the corporation's promise to provide [future medical care, in addition to] lifetime lodging and various services . . . . "[51] The court rejected the IRS's assertion "that no legal obligation to pay such amount existed simply because most of the services promised with respect to such payment would not be received until future

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[47] 26 T.C. 619 (1956).

[48] 52 T.C. 521, 532 (1969).

[49] *See* G.C.M. 34,561 (July 26, 1971); Rev. Rul. 76-481, 1976-2 C.B. 82; Rev. Rul. 75-303, 1975-2 C.B. 87; Rev. Rul. 75-302, 1975-2 C.B. 86. *See also* P.L.R. 83-09-011 (Nov. 19, 1982); P.L.R. 80-11-123 (Nov. 29, 1979); P.L.R. 78-07-093 (Nov. 21, 1977). Although private letter rulings may not be cited as legal precedent, they reveal the IRS's position on an issue.

[50] 79 T.C. 313 (1982), *acq.*, *action on decision* 1984-051 (July 16, 1984).

[51] *Id*. at 322.

years."[52] The IRS acquiesced[53] and has continued to allow deduction of the medical expense portion of entrance fees in every private letter ruling subsequently released on the issue.[54]

a. Amortizing entrance fee medical expenses. As mentioned in the example in section I.B., some CCRCs are erroneously advising their residents to amortize the deductible medical expense portion of the entrance fee over the 30- or 40-year life of the facilities mortgage. In other words, the residents may deduct only one-thirtieth or one-fortieth of the entrance fee medical expense portion each year. Neither the Service nor the Code permits amortizing medical expenses. Such expenses must be deducted in the year paid or in the year the legal obligation to provide the services accrues. The legal obligation of the CCRC accrues when the contract is signed and the entrance fee is paid. Hence, the entire medical deduction must be taken at that time. In fact, residents who follow the CCRCs' advice risk having the IRS deny such deductions in the years following the year of payment.

These CCRCs use a legal structure whereby the entrance fees are paid into a trust that in turn makes monthly payments on the facilities mortgage. Because of this, they maintain that their residents are not directly paying the medical expenses and may only take a deduction for the medical expense portion of the fee paid monthly by the trust. Nonetheless, the CCRCs' serpentine legal structure does not negate the fact that the residents pay the entrance fee in exchange for the future provision of health care. The

[52] *Id.*

[53] *Action on decision* 1984-051 (July 16, 1984).

[54] *See, e.g.*, P.L.R. 89-30-023 (Apr. 27, 1989); P.L.R. 87-48-026 (Aug. 31, 1987); P.L.R. 86-30-005 (Apr. 4, 1986); P.L.R. 84-10-057 (Dec. 6, 1983).

IRS[55] and the courts[56] have used the step transaction doctrine for many years to defeat taxpayers' creativity in laundering a transaction through a number of steps to avoid the undesired tax consequence of the basic transaction.

These CCRCs and their tax counsel, we believe, are incorrectly advising their residents and, in doing so, are denying them their right to a sizeable medical expense deduction in the year the entrance fee is paid. Moreover, it is unlikely that many residents will live the 30 years necessary to realize their full deduction, much less 40 years! We strongly recommend that these CCRCs correct their advice to their residents.

3. Recent IRS rulings and Internal Revenue Code amendments.

a. IRS restricts current-year deductibility. In the 1990's, however, the winds of deduction have chilled slightly. Late in 1993, the Service denied deductibility of current payments for future medical care when made to non-lifetime-care providers.[57] The ruling, which applied to contracts entered into after October 13, 1993, stated that the earlier revenue rulings[58]

> should not be interpreted to allow a current deduction of payments for future medical care (including medical insurance) extending substantially beyond the close of the taxable year in situations where the future care is not purchased in connection with obtaining lifetime care of the type described in those rulings.[59]

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[55] *See, e.g.,* Reg. § 1.482-2(a)(3)(i) (1989); Rev. Rul. 90-95, 1990-2 C.B. 67. *See also* Rev. Rul. 79-250, 1979-2 C.B. 156 (defining the step transaction doctrine as follows: "The step transaction doctrine generally permits a series of formally separate steps to be amalgamated and treated as a single transaction if they are in substance integrated, interdependent, and focused toward a particular end result.").

[56] *See, e.g., Commissioner v. Clark*, 489 U.S. 726, 738 (1989); *Biggs v. Commissioner*, 632 F.2d 1171, 1177-78 (5th Cir. 1980); *Redwing Carriers, Inc. v. Tomlinson*, 399 F.2d 652, 658 (5th Cir. 1968); *Vest v. Commissioner*, 57 T.C. 128, 145 (1971).

[57] Rev. Rul. 93-72, 1993-2 C.B. 77.

[58] *See, e.g.,* Rev. Rul. 76-481, 1976-2 C.B. 82; Rev. Rul. 75-303, 1975-2 C.B. 87; Rev. Rul. 75-302, 1975-2 C.B. 87.

[59] Rev. Rul. 93-72, 1993-2 C.B. 77.

On the same day, the IRS issued Revenue Procedure 93-43 stating that they would no longer issue advance rulings or determination letters as to "[w]hether amounts paid for medical insurance (or other medical care) extending substantially beyond the close of the taxable year may be deducted under section 213 of the Code in the year of payment, if the conditions of section 213(d)(7) are not satisfied."[60]

Unlike the ruling, the revenue procedure includes CCRC-type life care contracts in the refusal to issue advance rulings. In so doing, the IRS seems to imply its increasing discomfort with current-year deductibility of entrance fee related medical expenses. However, we are not apprehensive for four reasons: (1) *Estate of Smith*[61] is on point in allowing the deduction, and the IRS would have to reverse its acquiescence,[62] (2) Congress passed the Health Insurance Portability and Accountability Act of 1996 which overrides the ruling and now permits current deductibility of long-term care insurance premiums,[63] (3) an attorney with the IRS's Office of the General Counsel advised us that they are continuing to allow CCRC residents to take the entire medical portion of the entrance fee in the year paid because the obligation to pay has arisen,[64] and (4) the CCRC lobby -- both providers and residents -- is powerful. For example, the lobby garnered broad Congressional support both in preventing application of the below-market-rate loan

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[60] 1993-2 C.B. 544. The IRS has reiterated its prohibition on issuing rulings and determination letters each year since 1993. *See, e.g.*, Rev. Proc. 97-3, 1997-1 I.R.B. 85.

Section 213(d)(7) allows individuals under 65 a deduction for health insurance premiums paid in the current year for medical coverage after they reach 65 if certain payment specifications are met. Section 213(d)(7) and its implications for CCRCs' nursing care insurance are discussed in more depth in part 4 *infra* of this section and in section II.E. *infra*.

[61] 79 T.C. at 322, *acq.*, *action on decision* 1984-051 (July 16, 1984).

[62] The Service has occasionally reversed its acquiescence. *See, e.g.*, *Gustafson v. Commissioner*, 3 T.C. 998 (1944), *acq.*, *action on decision* 1944 C.B. 12, *non-acq.*, Rev. Rul. 73-529, 1973-2 C.B. 37, *and announced* at 1973-2 C.B. 4.

[63] Section 322(b) of the Act amended I.R.C. § 213(d)(1)(D) by adding the long-term care insurance provision.

[64] Telephone interview with attorney from the IRS's Office of the Chief Counsel (Feb. 3, 1995).

rules to the refundable portion of most CCRC entrance fees[65] and in overriding Revenue Ruling 93-72[66] to permit current deductibility of long-term care insurance.[67]

Unfortunately our optimism is not shared by some tax professionals. One big-5 accounting firm refused to give a comfort letter to a CCRC wishing to advise its residents as to the full, current deductibility of the portion of an entrance fee allocable to future medical care.[68] We believe such conservatism, despite the ruling's[69] exemption of CCRC-type contracts, is a disservice to CCRC clients and especially to CCRC residents.[70]

b. Congress clarifies deductible medical care services for ALU and nursing care residents. On January 1, 1997, the Health Insurance Portability and Accountability Act of 1996 authorized a medical deduction for qualified long-term care

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[65] On October 9 and 10, 1984, letters protesting the imputation of interest on refundable CCRC entry fees and signed by 21 Senators and 58 Representatives respectively were sent to the Acting Assistant Treasury Secretary. *See Senators and Congressmen Rally to Prevent Taxation of Elderly,* 25 Tax Notes 489, 559 (Nov. 5, 1984)**.**

[66] 1993-2 C.B. 77.

[67] *See, e.g.*, *Peterson Bill Would Provide Long-Term Care Insurance Incentives*, Tax Notes Today (Nov. 9, 1995) (LEXIS, FEDTAX lib., TNT file, elec. cit. 95 TNT 220-53); *Hatch Bill Would Reform Long-Term Care*, Tax Notes Today (Aug. 23, 1995) (LEXIS, FEDTAX lib., TNT file, elec. cit. 95 TNT 165-23); *Treat Long-Term Care Like Health Insurance, W & M Hearing Witnesses Say*, Tax Notes Today (Jan. 23, 1995) (LEXIS, FEDTAX lib., TNT file, elec. cit. 95 TNT 14-4).

[68] Telephone interview with a CPA formerly at a CCRC (Apr. 19, 1995) (stating that a Big-5 accounting firm became uncomfortable with issuing an opinion on the cost allocation due to the issuance of Rev. Rul. 93-72, 1993-2 C.B. 77; the CPA believed that the CCRC's contract did not provide future lifetime care, even though the contract was similar to ones in the past and still obligated the CCRC to provide lifetime care.).

[69] Rev. Rul. 93-72, 1993-2 C.B. 77.

[70] The Big-5 has continued to misinterpret tax issues affecting CCRCs. Per a telephone conversation with Kathleen Harris, A.V. Powell & Associates, Inc. (Jan. 21, 1998), a representative of another Big-5 accounting firm stirred up a storm at the Fall 1997 Annual Meeting of the American Association of Homes and Services for the Aging (AAHSA) by suggesting inaccurately that the Health Insurance Portability and Accountability Act of 1996 restricts the entrance and monthly fee medical expense deduction by CCRC residents. Paul A. Gordon, Chair of the AAHSA Legal Committee, responded with a memorandum that the Act has not adversely affected the deductibility of the medical expense portion of the fees. Memorandum from Paul A. Gordon, Chair of the AAHSA Legal Committee, to the members of AAHSA CCRC, *Deductibility of Portion of Entrance Fees and Monthly Fees as a Medical Expense* (Nov. 21, 1997).

insurance contracts[71] and, of significance to CCRC residents, a medical deduction for "qualified long-term care services."[72]

"Qualified long-term care services"[73] performed by a "licensed health care practitioner"[74] for a "chronically ill individual"[75] include "maintenance or personal care services"[76] in addition to the diagnostic, preventative, therapeutic, curing, treating, mitigating, and rehabilitative services previously allowed under section 213.[77] The Code defines the chronically ill as those who are certified by a licensed health care practitioner and those who are unable to perform for a minimum of 90 days at least two out of six activities of daily living (ADLs) which include eating, toileting, transferring (*e.g.*, from bed to chair), bathing, dressing, and continence.[78] "Maintenance or personal care services" mean any care or assistance with any of the ADLs that caused the person to be classified as chronically ill.[79] All nursing care residents and most ALU residents are "chronically ill" under the new law[80] because they have at least two or three ADLs.[81] Although the new law does not affect the longstanding deductibility of the medical care

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[71] Section 322(b) of the Act amended I.R.C. section 213(d)(1)(D) by adding the long-term care insurance provision. This overrides Rev. Rul. 93-72, 1993-2 C.B. 77, as discussed in section II.B.3.a.

[72] The Health Insurance Portability and Accountability Act of 1996, § 322. The Act redesignates the previous subparagraph (C) of I.R.C. § 213(d)(1) as subparagraph (D) and added a new subparagraph (C) that contains the long-term care provision.

[73] I.R.C. § 213(d)(1)(C) (defined in I.R.C. § 7702B(c)(1)).

[74] I.R.C. § 7702B(c)(4) defines "licensed health care practitioner" as a physician, registered nurse, licensed social worker, or other individual who meets the requirements prescribed by the IRS. CCRCs generally have nurses and other professionals on staff who should qualify.

[75] I.R.C. § 7702B(c)(2).

[76] I.R.C. § 7702B(c)(1).

[77] *Compare* I.R.C. § 213(d)(1) *with* new I.R.C. § 7702B(c)(1).

[78] *See* I.R.C. § 7702B(c)(2), which was added by § 321(a) of the Health Insurance Portability and Accountability Act of 1996.

[79] I.R.C. § 7702B(c)(3).

[80] Section 321(a) of the Health Insurance Portability and Accountability Act of 1996 added I.R.C. § 7702B(c)(2) which defines a "chronically ill individual."

[81] ALU residents with more than four ADLs usually must move to the nursing care facility.

portion of fees paid by ILU residents[82] or the full deductibility of fees paid by nursing care residents,[83] it strengthens the full deductibility of ALU monthly fees by defining deductible medical care services for ALU residents.[84] Consequently, CCRCs should categorize all the costs of caring for most ALU residents as medical expenses, namely the residents' full monthly fees.[85]

4. Is the medical portion of a life care contract medical insurance? We believe it is, consistent with the 1971 G.C.M.[86] discussed in section II.B.1. In reviewing two proposed revenue rulings, the IRS's General Counsel argued that the medical expense portion of an entrance fee qualifies as medical insurance, stating that the typical contract between a CCRC and a resident includes "the essential elements of insurance": ". . . an insurable risk, a shifting of that risk from one to another, [and] a distribution of the risk . . ." across all the resident insureds.[87] The memorandum followed *Helvering v. Le Gierse*, which defined insurance as involving "risk-shifting and risk-distributing" and defined health insurance in particular as indemnifying a person for losses caused by illness.[88] Because a CCRC guarantees the performance of the medical services and is

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[82] *See* I.R.C. § 213(d)(1)(A).

[83] *See* discussion *infra* Section II.C.

[84] We disagree with A. Mark Christopher, who wrote that "[t]he new rules also should significantly alter the calculation of deductible expenses paid by healthy residents of CCRCs . . . [and] increase the deductible portion of fees paid to these types of facilities." Christopher, *supra* note 10, at 25. We believe that the new law merely clarifies and supports what was being deducted previously.

[85] This includes the meals and lodging portion of the monthly fees, and is consistent with Reg. § 1.213(e)(1)(v)(a) (as amended in 1979) which states:

> Where an individual is in an institution because his condition is such that the availability of medical care . . . in such institution is a principal reason for his presence there, and meals and lodging are furnished as a necessary incident to such care, the entire cost of medical care and meals and lodging at the institution, which are furnished while the individual requires continual medical care, shall constitute an expense for medical care.

[86] G.C.M. 34,561 (July 26, 1971). *See supra* note 33 and accompanying text.

[87] G.C.M. 34,561 (July 26, 1971) at 4.

[88] 312 U.S. 531, 539 (1941).

liable for the acts of the service providers, it assumes the risk of medical care and does not merely act as an agent in procuring medical care for the residents. Hence, the medical expense portion of a CCRC residential contract was deemed to be medical insurance.[89]

When the rulings were finally issued in 1975,[90] the Service reversed itself and rejected the insurance rationale. First, the Service maintained that the CCRC entrance fee ". . . was calculated without regard to any similar contracts with other patients at the institution and assured the taxpayer lifetime care at no additional cost and, therefore, was not medical insurance."[91] In other words, the IRS concluded that there was no distribution of risk. We disagree. First, CCRCs typically base their contract fees on the actuarially determined mortality and morbidity (illness) rates of their residents; therefore, *ipso facto* they take into consideration similar contracts with other residents. Second, the IRS argued that the taxpayer was assured care at no additional cost. Although the CCRC offered its residents contracts of the extensive type guaranteeing lifetime care at no *increase* in cost, it undoubtedly charged a higher fee than CCRCs offering modified or fee-for-service contracts. Third, per *Haynes v. United States,* nothing in the Code restricts insurance to that provided by commercial companies.[92]

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[89] For a discussion of the similarities between CCRC contracts and insurance, see Mark R. Greene, *Life Care Centers - A New Concept in Insurance*, 48 J. of Risk and Ins. 403 (Sept. 1981). The article addresses pricing and contractual arrangements rather than the legal definition of insurance.

[90] Rev. Rul. 75-303, 1975-2 C.B. 87; Rev. Rul. 75-302, 1975-2 C.B. 86.

[91] Rev. Rul. 75-302, 1975-2 C.B. 86. *See also* Rev. Rul. 75-303, 1975-2 C.B. 88 (rejecting the insurance rationale more tersely, stating, "[t]he fee was calculated without regard to contracts for care involving other patients and, therefore, was not medical insurance.").

[92] 353 U.S. 81, 84 (1957).

Despite the IRS's reversal,[93] we believe the medical portion of an entrance fee is deductible as insurance.[94] The principal beneficiaries are those CCRC residents with self-employment income. They may deduct 45% of the medical portion of their monthly fees as a self-employment medical insurance adjustment to income,[95] not to exceed their self-employment net income.[96] The remaining 55% of the entrance fee medical portion (more if the deduction was limited by self-employment income) is an itemized deduction.

In the next three sections, we address the impact of nursing facility fees, fees designated for building a medical facility, and nursing care upgrade fees on residents' medical deductions.

C. Deductibility of ALU and Nursing Unit Fees.

All of the monthly fees including room and board charges for nursing facility residents and most ALU residents are deductible as medical expenses as long as the need for medical care is a principal reason for residency.[97] Just as meals and lodging included

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[93] The enactment of the Health Insurance Portability and Accountability Act of 1996 may undermine our assertion that the medical care portion of an entrance fee is insurance. By carefully defining a "qualified long-term care insurance contract," Act § 321(a) which added I.R.C. § 7702B(b) could be construed as excluding CCRC contracts that do not strictly fit the definition from being considered a type of insurance.

[94] I.R.C. § 213(d)(7) should not prevent a full deduction of the medical portion of an entrance fee if it is deemed medical insurance. Section 213(d)(7) specifies that medical insurance premiums paid during the year by taxpayers under 65 for coverage after they reach 65 are fully deductible in the year paid only if the premiums are payable in equal installments over a period of ten years or more. Most new residents are 65 or over, and those that are under 65 are actually buying coverage that starts immediately rather than after they turn 65. Moreover, the Tax Court has consistently held that full deductibility in the year paid is allowed if the person has a legal obligation to pay in order to obtain the future medical care. *See Estate of Smith*, 79 T.C. 313, *acq.*, *action on decision* 1984-051 (July 16, 1984); *Rose v. Commissioner*, 52 T.C. 521 (1969); *Bassett v. Commissioner*, 26 T.C. 619 (1956); discussion *supra* section II.B.2.

[95] I.R.C. § 162(l)(1)(B). The percentage remains at 45% in 1999 and rises in steps thereafter to 100% in 2006.

[96] I.R.C. § 162(l)(2)(A).

[97] Reg. § 1.213(e)(1)(v)(a) (as amended in 1979). *See supra* note 28.

in a hospital bill have long been deductible medical expenses,[98] they are also deductible when incurred at an institution other than a hospital if a principal reason for residing there is the availability of medical care and if the meals and lodging are a necessary part of such care.[99] Medical care does not need to be *the* principal reason, merely *a* principal reason.[100]

Thus, the entire monthly fee amount is deductible even though the availability of medical care may be just one of several principal reasons for the resident's presence in the ALU or nursing facility, such as if the resident's family is unable to provide care at home. If the availability of medical care is not a principal reason for ALU or nursing facility residence, then only the portion attributable to medical care is deductible.[101] Determining the correct portion is a key issue which we examine in section IV.

D. Deductibility of Fees Designated for Building a Medical Facility

If a CCRC indicates that part of the entrance fee is for building a medical facility, that portion is non-deductible. In Revenue Ruling 68-525,[102] reiterated in Revenue Ruling 76-481,[103] the Service denied a medical expense deduction for the entrance fee

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[98] I.R.C. § 213(d)(1)(B); Reg. § 1.213(e)(1)(v)(a) (as amended in 1979). *See also* H. R. Rep. No. 1337, 83d Cong., 2d Sess. (1954) (enacted); S. Rep. No. 1622, 83d Cong., 2d Sess. (1954) (enacted) (stating in part: "The subsection [subsection (e), now subsection (d), of I.R.C. section 213] is not intended . . . to deny the cost of food or lodging provided as part of a hospital bill.").

[99] Reg. § 1.213(e)(1)(v)(a) (as amended in 1979).

[100] In *Counts v. Commissioner*, 42 T.C. 755 (1964), the Tax Court clarified that the regulations state that availability of medical care merely need be *a* principal reason rather than *the* principal reason for the person's presence in the institution. Compare this with *Robinson v. Commissioner*, 422 F.2d 873 (9th Cir. 1970), in which the deduction for meals and lodging was denied because medical care was not a principal reason for the petitioner's dependent parents being in a rest home.

[101] Reg. § 1.213-1(e)(1)(v)(b) (as amended in 1979).

[102] 1968-2 C.B. 112.

[103] 1976-2 C.B. 82.

portion designated for building a medical facility at a CCRC. Capital expenditures are normally not deductible per section 263.[104]

To secure deductibility of medical facility costs for the residents, CCRCs should construct the medical facilities with funds borrowed from another source rather than financing them through entrance fee proceeds. The entrance fees received from the residents may then be used to amortize the loans and cover the depreciation. Just as a hospital bill is deductible even though it includes depreciation charges to recover building costs, so is the medical care portion of a CCRC fee which includes the costs of the depreciation and interest on a medical facility.

In their tax information notices to residents, CCRCs should include capital recovery or depreciation costs as part of their medical care costs rather than identifying them as costs of building a medical facility.[105]

E. Deductibility of ALU and Nursing Care Upgrade Fees

Some CCRCs offer new residents entering under modified ALU and nursing care contracts[106] an opportunity to upgrade to an extensive care contract. The upgrade guarantees that the residents will pay no more than their normal ILU monthly fee if they

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[104] *See* Reg. § 1.213-1(e)(1)(iii) (as amended in 1979). *See also Ferris v. Commissioner*, 582 F.2d 1112 (7th Cir. 1978) (disallowing a couple's attempt to take an $86,000 medical expense deduction for a $194,600 swimming pool addition to their home). Medically related capital expenditures that improve one's own property are deductible if it is proven that the market value of the property has increased by less than the amount of the capital expenditure, in which case the difference is deductible.

[105] If a CCRC classifies part of the entrance fee for building medical facilities, that portion could be deemed part of the refundable portion of the fee. As we caution in section III.C. *infra*, the medical expenses attributable to the refundable portion of the fee may not be deductible in which case the nondeductibility of the medical facility expenses would not be an issue.

[106] For further description of modified-care contracts, see *supra* section I.C.

require assisted living or are admitted to the nursing care facility.[107] CCRCs typically offer one of two payment versions for the upgrade: a higher entrance fee or a lower refundable percentage of the entrance fee upon termination of residence. Under either version, 100% of the cost is deductible in the year paid because payment is contractually obligated in order to secure the guarantee of future care as discussed in section II.B.2., and because, for the reduced refund version, payment is effectively made at the time the entrance fee is paid. Based on our analysis in section II.B.4., we believe both upgrades constitute a type of medical insurance, or more specifically, long-term care insurance. The Health Insurance Portability and Accountability Act of 1996[108] overrides the IRS's disallowance under Revenue Ruling 93-72[109] of a current deduction of payments for future medical care and now permits the current deductibility of long-term care insurance premiums.

Section 213(d)(7) should not prevent deduction of an ALU or nursing care upgrade fee unless, perhaps, the resident is under 65 years old. Section 213(d)(7) specifies that medical insurance premiums paid during the year by taxpayers under 65 for coverage after they reach 65 are fully deductible in the year paid only if the premiums are payable in equal installments over a period of ten years or more. Most new residents are 65 or over, and those that are under 65 are actually buying coverage that starts immediately rather than after they turn 65. Moreover, the Tax Court has consistently

[107] Generally, a modified-contract CCRC allows residents to spend a certain maximum number of days in the nursing care facility without paying extra monthly fees. Unless the additional coverage is purchased in advance, the resident will be required to pay extra for use of the nursing care facility beyond the maximum number of days.

[108] Section 322(b) of the Act amended I.R.C. § 213(d)(1)(D) by adding the long-term care insurance provision.

[109] 1993-2 C.B. 77. *See* discussion *supra* in section II.B.3.a.

held that full deductibility in the year paid is allowed if the person has a legal obligation to pay in order to obtain the future medical care.[110]

III. Tax Treatment of Entrance Fee Refunds

Particularly vexing is the proper tax treatment of an entrance fee refund. Hence, almost half of our analysis addresses this concern. Because entrance fee refunds are typically paid without interest, the first issue involves the section 7872 below-market-rate loan rules. The second issue considers whether the medical expense deduction should be taken on the full entrance fee or the net fee, *i.e.*, the entrance fee less the refundable portion. As part of examining this second issue, we explain the effect of an entrance fee refund on a decedent resident's estate and heirs.

A. Introduction

Most entrance fee contracts provide for a refund following the termination of residency, either to the residents if they move out prior to death or to their estates. Refunds typically vary from 10% to 100% of the entrance fee depending on the CCRC and the length of residence. Many contracts contain a refund adjustment or penalty provision under which the refundable percentage declines monthly or annually after the date of initial residency until some percentage floor is reached. For example, a residence contract might specify that the refundable amount declines by 2% each month until a

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[110] *See Estate of Smith*, 79 T.C. 313, *acq.*, *action on decision* 1984-051 (July 16, 1984); *Rose*, 52 T.C. 521; *Bassett*, 26 T.C. 619; discussion *supra* section II.B.2.

floor of 50% is reached. Generally, no interest is paid. Because non-interest-bearing refunds are considered below-market-rate loans per section 7872, and because the peculiarities of these provisions have a significant impact on the tax treatment of the refunds, we discuss the below-market-loan rules first.

B. Tax Effects of the Section 7872 Below-Market-Rate Loan Rules on the Refundable Portion of an Entrance Fee

1. Background. The section 7872 below-market-rate loan rules were enacted in 1984[111] and require that a lender recognize imputed interest income and a borrower recognize imputed interest expense on loans bearing an interest rate less than the market rate. Although not specifically mentioned in the initial statute, refundable entrance fee (loan) arrangements between CCRCs and their residents were thought to be included under I.R.C. § 7872(c)(1)(E). Responding to political pressure from CCRCs and residents,[112] Congress enacted section 7872(g) in 1985[113] to exempt below-market-rate loans between residents over 64 years old by the end of the tax year[114] and *qualified* CCRCs up to the first $90,000 of an entrance fee refund, adjusted for inflation.[115] For 1998, the exempt amount is $134,800.[116]

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[111] Section 172(a) of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 699-703 was effective for term loans made after June 6, 1984 and for demand loans outstanding after June 6, 1984.

[112] *See* Senators, *supra* note 65.

[113] Pub. L. No. 99-121, 99 Stat. 505, 511 (1985). The 1985 amendment clarified that § 7872 applies to loans to qualified continuing care facilities by adding I.R.C. § 7872(c)(1)(F), but then the amendment excluded most such loans by adding I.R.C. § 7872(g).

[114] I.R.C. § 7872(g)(1).

[115] The IRS has ruled in P.L.R. 92-52-015 (Sept. 24, 1992) that a non-interest-bearing refundable portion of an entrance fee is a loan for the purposes of I.R.C. § 7872.

[116] Rev. Rul. 97-57, 1997-52 I.R.B. 16. Where an entrance fee refund decreases by the length of residence, the below-market loan amount will decrease accordingly over time, thus decreasing the portion, if any, subject to the below-market-rate loan rules. For example, if the refundable percentage of a $250,000 entrance fee decreases by 10%

Few residents of qualified CCRCs need be concerned with the below-market-rate loan rules because most refunds are less than the $134,800 current exemption amount.[117] In fact, almost all refunds will be exempt if the discounted present value is used, as discussed in section III.B.3.

For a CCRC to qualify for the exemption, it must meet a number of conditions listed in section 7872(g)(4). In particular, "substantially all of the residents [must be] covered by continuing care contracts,"[118] and "substantially all facilities must be owned or operated by [the CCRC]."[119] Although most CCRCs qualify, all residents of *non-qualified* CCRCs, regardless of the residents' ages, are currently exempt from the section 7872 rules.

Thanks to bureaucratic delay, section 7872 does not currently cover loans between residents and non-qualified CCRCs, regardless of the amount of the guaranteed refund. In 1985, the Service issued proposed regulations that classified certain loans including loans to CCRCs as significant effect loans under section 7872. Declining to give guidelines as to the handling of significant effect loans, the Service stated, "[n]o transaction will be treated under the regulations as a significant effect loan earlier than the date that future regulations under section 7872(c)(1)(E) are published in proposed form."[120] As yet, the proposed regulations have not been issued.[121] Consequently,

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on the first day of each year of residence until a 50% floor is reached in the fifth year, the loan amount under I.R.C. § 7872 would be $225,000 in the first year, $200,000 in the second year, *etc.*, until the $125,000 floor is reached in the fifth year of residence.

[117] *Id.*

[118] I.R.C. § 7872(g)(4)(A)(ii).

[119] I.R.C. § 7872(g)(4)(B).

[120] Notice of Proposed Rulemaking Below-Market Loans, 50 Fed. Reg. 33,553 (Aug. 20, 1985), 1985-2 C.B. 812, 814.

[121] P.L.R. 97-35-002 (May 5, 1997) reiterates that the proposed regulations have not yet been issued. Prop. Reg. § 1.7872-4(f) (1985) remains reserved for this purpose.

below-market-rate significant effect loans are presently exempt from the section 7872 requirements. The remarkable effect of this delay is that refundable entrance fee arrangements of any dollar amount between non-qualified CCRCs and their residents are not subject to the below-market loan rules.[122]

The IRS issued the proposed regulations on August 20, 1985,[123] almost three months prior to the enactment of section 7872(g),[124] which applied only to qualified CCRCs. Had section 7872(g) not been enacted, all loans between CCRCs and residents of any age would currently be exempt because there would be no such classification as a "qualified" CCRC!

2. The refundable portion of an entrance fee should be treated as a term loan rather than a demand loan under section 7872. An important issue for *qualified* CCRCs and their residents is whether the refundable portion of an entrance fee is considered a demand or term loan. Term loans are valued at discounted present value under section 7872 whereas demand loans are valued at face value per section 7872(e)(1)(A). Discounting offers three distinct benefits to CCRCs and their residents. First, valuing an entrance fee refund at the discounted present value rather than at its full value will exempt more refunds from the below-market-rate loan rules. Second, discounting produces a higher net entrance fee — the entrance fee less the discounted

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[122] In T.A.M. 95-21-001 (Dec. 7, 1994), the IRS verified that the refundable entrance fee paid by the residents of a non-qualified CCRC is classified as a "significant effect" loan under I.R.C. § 7872(c)(1)(E).

Two articles that have reviewed the T.A.M. are misleading. The first article quoted the T.A.M. as referring to non-qualified CCRCs, but the author neglected to clarify that the T.A.M. only applied to non-qualified CCRCs. *See* Kenneth N. Orbach, CPA, *IRS Rules Favorably on Significant Effect Below-Market Loan*, 26 Tax Advisor 532 (1995). The omission was more serious in the second article. No mention at all was made of the qualified versus non-qualified CCRC issue, thus implying that the ruling applied to non-interest-bearing refund contracts with all CCRCs. *See* Michael F. Lynch, CPA, *Giving Below-Market Loans to Retirement Facilities*, 180 J. of Acct. 37 (1995).

[123] Notice of Proposed Rulemaking Below-Market Loans, 50 Fed. Reg. 33,553 (Aug. 20, 1985), 1985-2 C.B. 812, 814.

[124] Enacted on October 11, 1985. *See* Pub. L. No. 99-121, § 201, 99 Stat. 505, 510 (1985).

present value of the refund — on which the deductible medical expense portion may be calculated, as discussed in section III.C.2. Third, imputed interest (amortization of the original issue discount) will be calculated on the discounted present value rather than on the full refund, resulting in lower reportable interest income by the resident and lower interest expense by the CCRC as well.

We first discuss the rationale for treating an entrance fee refund as a term rather than demand loan. We then explain why a refund may be valued at its discounted present value rather than at the full value in determining the exempt amount from the section 7872 below-market-rate loan rules.

In the first ruling to touch on the term versus demand loan issue, the IRS treated an entrance fee refund as a below-market-rate *demand* loan, because the contract with the CCRC allowed the resident to demand payment by terminating residency.[125] We disagree. In the analysis section of the ruling, the Service paraphrased section 7872(f)(5), saying that the refund "can be characterized as a demand loan because it is payable at any time on the demand of the lender.[126] Section 7872(f)(5) defines three types of loans as demand loans:

> [Type 1:] The term "demand loan" means any loan which is payable in full at any time on the demand of the lender. [Type 2:] Such term also includes . . . any loan if the benefits of the interest arrangements of such loan are not transferable and are conditioned on the future performance of substantial services by an individual. [Type 3:] To the extent provided in regulations, such term also includes any loan with an indefinite maturity.[127]

If a loan — in this case, an entrance fee refund — is to avoid classification as a demand loan, it must fail all three definitions.

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[125] P.L.R. 92-52-015 (Sept. 24, 1992). *See also supra* note 115 and accompanying text.

[126] P.L.R. 92-52-015 (Sept. 24, 1992).

[127] *Id.*

First, the refund cannot be payable in full at any time on the demand of the lender. Normally an entrance fee refund is not due until death unless a resident terminates residency earlier. We assert that the option to receive the refund by terminating residency before death is not payment on demand, contrary to the IRS's conclusion in the letter ruling,[128] but is a prepayment option:

> Acceleration clauses and similar provisions that would make a loan due before the time otherwise specified including provisions permitting prepayment of a loan . . . are disregarded for the purposes of section 7872. Thus, a loan for a term of 15 years is a term loan for 15 years even if is it subject to [such provisions].[129]

Second, the benefits of the interest arrangements — those of not charging interest on the refundable portion of CCRC entrance fees — are not transferable. Also, the benefits are undoubtedly conditioned on the future performance of substantial services by a CCRC, not by an *individual*. CCRCs are organized as corporations, partnerships, or trusts, none of which the Code classifies as an individual.[130]

Third, the refundable entrance fee must not have an indefinite maturity.

> A loan is treated as a 'term loan' if the loan agreement specifies an ascertainable period of time during which the loan is to be outstanding. For the purposes of this rule, a period of time is treated as being ascertainable if the period may be determined actuarially. Thus, a loan [for one's lifetime] will be treated as a term loan because the life expectancy [of the person] may be determined actuarially.[131]

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[128] *Id.*

[129] Prop. Reg. § 1.7872-10(a)(3) (1985).

[130] The Internal Revenue Code does not define "individual" *per se*, but in every reference we have seen, it refers to a human being. I.R.C. § 7701(a)(1) states that: "The term 'person' shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation." We doubt whether the courts might construe "individual" more broadly, but who is to say? Alice in Wonderland faced a similar challenge:

> 'When *I* use a word,' Humpty Dumpty said in a rather scornful tone, 'it means just what I choose it to mean -- neither more nor less.'
> 'The question is,' said Alice, 'whether you *can* make words mean so many different things.'
> 'The question is,' said Humpty Dumpty, 'which is to be master -- that's all.'

Lewis Carroll, *Through the Looking-Glass* 106 (Schocken Books, 1987).

[131] Prop. Reg.§ 1.7872-10(a)(2) (1985).

This describes a typical lifetime contractual agreement between a CCRC and its residents; the entrance fee is paid in consideration for the CCRC's guarantee to provide them with lifetime care. An entrance fee refund, therefore, is not a demand loan of indefinite maturity but rather a term loan with an actuarially ascertainable maturity.

Because the normal CCRC entrance fee refund contract fails all three demand loan definitions, the refund should be treated as a term loan per section 7872(f)(6) which states: "The term 'term loan' means any loan which is not a demand loan."[132] It may then be discounted as discussed next.

3. Term loan discounting will significantly reduce the amount of an entrance fee refund that is subject to the below-market-rate loan rules. Although section 7872(b) allows for the discounting of term loans, section 7872(g) does not specify whether the discounted present value or the face value is applicable for determining whether an entrance fee refund exceeds the exemption amount. The difference is considerable. A non-interest-bearing, fully-refundable $250,000 entrance fee paid by new residents as old as their late seventies would have a discounted present value of less than the current $134,800 exemption amount[133] based on the residents' actuarial life and the applicable discount rate[134] and thus would be exempt from the section 7872 below-market-rate loan rules.[135] On the other hand, if the face value of the entrance fee refund

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[132] Unfortunately, the legislative history provides no further guidance as to whether an entrance fee refund is a demand or term loan. *See* H. R. Rep. No. 98-432, pt. 2 (1984), *reprinted in* 1984 U.S.C.C.A.N. 697; H.R. Conf. Rep. No. 98-861 (1984), *reprinted in* 1984 U.S.C.C.A.N. 1445; S. Rep. No. 98-50 (1984), *reprinted in* 1984 U.S.C.C.A.N. 2174; S Rep. No. 98-297 (1984), *reprinted in* 1984 U.S.C.C.A.N. 2213. These documents accompany the Deficit Reduction Act of 1984.

[133] Rev. Rul. 97-57, 1997-52 I.R.B. 16.

[134] We explain the mechanics of this computation in section III.B.4. *infra*.

[135] Because no interest is imputed on the exempt amount, the loan should remain exempt from I.R.C. § 7872 until maturity. Nonetheless, based on the wording in I.R.C. § 7872(g)(2) that the "aggregate outstanding amount of any loan" must be considered, the Service could argue that the discounted present value of the loan is growing year by year.

were used, imputed interest includable in the resident's taxable income must be calculated on $118,700 of the $250,000. Based in part on statutory and administrative authority but primarily on case law, we assert that the discounted present value applies as follows.

a. Statutory and administrative authority. Statutory guidance is almost nonexistent. In establishing the exemption amount, section 7872(g)(2) provides no clarification as to which loan value applies, referring only to "the aggregate outstanding amount of the loan." For term loans, section 7872(b)(1) provides no further clarification, stating that "the borrower shall be treated as having received on such date, cash in an amount equal to the excess of the amount loaned, over the present value of all payments which are required to be made under the terms of the loan." The "definitions" subsection (f)(4) of section 7872 merely defines the "amount loaned" as meaning "the amount received by the borrower." The Congressional committee report provides no further clarification.[136]

Although the wording of the Code does not help determine the applicable amount, administrative regulations lean toward the discounted present value. Expanding on section 7872(b)(2), which states that the difference between the face amount of a term loan and its discounted present value is "original issue discount," Proposed Regulation section 1.7872-7(a)(3),[137] specifies that the discounted present value is the "issue price" and applies the section 1272 original issue discount (OID) rules to the amortization of the OID. By saying that the lender's basis equals the discounted present value of the loan in

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Consequently, imputed interest would have to be recognized on the excess at the point when it exceeds the inflation adjusted safe harbor amount.

[136] *See* H. R. Rep. No. 99-250 (1985) (accompanying H. R. 2475, 99th Cong. (1985)).

[137]

(1985).

the case of a term loan, Proposed Regulation section 1.7872-7(a)(6)[138] comes the closest of any administrative pronouncement to saying that the applicable value of a CCRC resident's entrance fee refund is the discounted present value. Case law provides stronger support.[139]

b. Case law. Although the Tax Court has resisted applying the concept of present value to Code sections that do not mention such calculations, it has assented for sections that do. In *Follender v. Commissioner*, the court rejected the IRS's attempt to discount the taxpayers' loan to its discounted present value in order to reduce the at-risk amount, stating that section 465 "does not allow for present value calculations, expressly or implicitly."[140] More recently, the court followed *Follender* in *City of New York v. Commissioner*.[141] In this case, New York City argued that the $4.8 million present value of a $15 million bond issue was the appropriate valuation for qualifying the bonds as tax exempt under the section 141(c) $5 million private loan financing threshold.[142] The City cited the inclusion of discounted present value in sections 1274 and 7872 as evidence that Congress recognizes the time value of money as an economic reality across the entire Code.[143] The court disagreed and declined to apply "this statutory trend to section 141(c)," citing the rationale used in *Follender*.[144] In both cases,

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[138] (1985).

[139] APB Opinion No. 21, as amended by FAS No. 34, also supports the use of discounted present value as the controlling amount that must be included in the liability section of a balance sheet. *See Interest of Receivables and Payables*, *Accounting Principles Board Opinion No. 21*, §§ 16, 20 (Accounting Principles Board, 1971). *See also Capitalization of Interest Cost, Statement of Financial Accounting Standard No. 34:* (Financial Accounting Standards Board, 1979) (amending § 21.16).

[140] 89 T.C. 943, 952 (1987).

[141] 103 T.C. 481, 487 (1994), *aff'd*, *City of New York v. Commissioner*, 70 F.3d 142 (D.C. Cir. 1995).

[142] *Id*. at 485-86.

[143] *Id*. at 494-95.

[144] *Id*. at 495.

the Tax Court rejected restating of loan amounts to their discounted present values for the purpose of qualifying for a statutory benefit or threshold in cases where the Code sections are silent on the discounting issue.

The Tax Court has ruled, however, in a situation involving a statute that explicitly allows discounting, specifically section 7872. In *Frazee v. Commissioner*, a gift tax case involving a below-market-rate loan under section 7872, the court stated: "The value of the promissory note, therefore, must be recomputed [discounted] . . . " and concluded that, "[t]he face amount of the loan, $380,000 less the discounted value, results in the additional gift of interest under section 7872."[145] In other words, term loans under section 7872 should be restated at their discounted present value, and the appropriate value for determining the exempt amount should be the discounted present value.

Dictum from the Seventh Circuit adds further support to using the discounted present value: "The new treatment of debt bearing interest less than market rates, 26 U.S.C. § 7872 (1986) [section 7872], added in 1984, would have required the [taxpayers] to restate the debt at its expected value . . . ."[146]

c. Effect on the resident of discounting an entrance fee refund.

Residents may significantly lower their exposure to the section 7872 below-market-rate loan rules by using the discounted present value of the entrance fee refund. In so doing residents will lower the amount of any imputed interest income that they must report in taxable income each year. We believe that CCRC residents may reasonably argue under section 7872 that the discounted present value is the appropriate measure for determining the amount of an entrance fee refund that is exempt under section 7872(g)(2). Beneficial

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[145] 98 T.C. 554, 590 (1992). Gift loans that are term loans are classified as such for gift tax purposes per I.R.C. § 7872(d)(2).

[146] *Levin v. Commissioner*, 832 F.2d 403, 408 (7th Cir. 1987).

as discounting may be to residents, however, it has the opposite effect on CCRCs as explained in section III.B.3.d. below.

What happens if the IRS disapproves of using discounted present value for section 7872(g)(2) exemption purposes? Although case law implies that the discounted present value is the correct amount for determining whether an entrance fee refund exceeds the section 7872(g)(2) exemption amount, we believe the IRS could take the position that the correct amount is the original, undiscounted loan amount and apply the section 7872 rules to the excess amount. In the event that the IRS should do so, we believe that the rationale of the courts cited above[147] should be sufficient to satisfy the substantial authority requirements of Regulation section 1.6662-4(d)(iii) regarding taking an aggressive tax return position contrary to the IRS's views. The substantial underpayment of income tax penalty will apply if the tax saved by not reporting the interest income from amortizing the discount exceeds the greater of $5,000 or 10% of the tax liability shown on the return.[148]

There is a safe harbor, however: adequate disclosure of the aggressive position.[149] We recommend that residents adequately disclose the nature of the discounting treatment by attaching Form 8275 (Disclosure Statement) to their returns.[150] Of course, the safest approach would be to use the full refund in calculating the amount subject to section 7872. We illustrate both approaches in Example 1 in section III.B.4.a. below.

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[147] *See Levin*, 832 F.2d 403*; City of New York*, 103 T.C. 481, *aff'd*, *City of New York*, 70 F.3d 142; *Frazee*, 98 T.C. 554; *Follender*, 89 T.C. 943.

[148] I.R.C. § 6662(d)(1)(A).

[149] *See* I.R.C. § 6662(d)(2)(B)(ii)(I); Reg. § 1.6662-4(e) (as amended in 1995).

[150] *See* Reg. § 1.6662-4(f)(1), (2) (as amended in 1995).

d. Effect on CCRCs of treating a refund as a discountable term loan. Treating the refundable portion of an entrance fee as a term loan rather than a demand loan benefits residents at the expense of taxable, for-profit CCRCs. Section 7872(b)(2) requires the discounting of term loans; subsection (b)(1) further states that the borrower — in this case, the CCRC — will be treated as receiving cash equal to the difference between the amount loaned, *i.e.*, the amount of the entrance fee refund, and the discounted present value. Consequently, CCRCs must report the difference — the amount of the discount — as income in the year the entrance fee is received.

In addition, Regulation section 1.61-8(b) requires that CCRCs recognize the portion of an entrance fee that is not refundable as taxable income in the year received regardless of either the period covered or the method of accounting used by the CCRC.[151] In contrast, the American Institute of Certified Public Accountant's *Statement of Position 90-8* maintains that the non-refundable portion should be accounted for as deferred revenue on the liability section of the balance sheet.[152] Moreover, according to *Highland Farms, Inc. v. Commissioner*, any pro-rata refundable portion of an entrance fee that expires (becomes non-refundable) during the year is also taxable income in that year.[153]

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[151] This is why some CCRCs have established an intermediary trust to receive the residents' entrance fees and to make payments on the building mortgage. With this legal structure, the CCRCs only have to recognize the monthly principal payments made on the mortgage as income.

[152] American Institute of Certified Public Accountants, *Statement of Position 90-8, Financial Accounting and Reporting by Continuing Care Retirement Communities; Amendment to AICPA Audit and Accounting Guide Audits of Providers of Health Care Services* (1993).

[153] 106 T.C. 237, 250-52 (1996). Residents who paid an entrance fee were entitled to a percentage refund at cessation of residence. The percentage declined with each year of residence. The court held that only the portion that became non-refundable each year had to be included in income. The refundable portion was not income in the year the entrance fee was paid. The court ruled that it was not an advance payment for services or prepaid rent because the CCRC did not have "'unfettered 'dominion' over the money [the full entrance fee] at the time of receipt.'" *Id.* at 252 (quoting *Commissioner v. Indianapolis Power and Light Co.*, 493 U.S. 203, 212 (1990)). "'The key is whether the taxpayer has some guarantee that he will be allowed to keep the money.'" *Id.* at 251 (quoting 493 U.S. at 210). As a result, the CCRC did not have "to include the entire amount of the entry fees in income in the year of receipt." *Id.* at 252. Per the court, "[t]his method of accounting for the entry fees clearly reflects income," *id.,* as specified in I.R.C. § 446(b).

4. Methods and examples of calculating the tax effects of section 7872 on a refund. Because an entrance fee refund may be considered a term loan for the life of the resident, the discounted present value must be determined using the resident's actuarial life at the time the entrance fee is paid. No specific guidance is given as to which actuarial tables to use. The section 72 annuity tables published in Regulation section 1.72-9 are probably the best. For a single resident's expected remaining life span, use *Table V — Ordinary Life Annuities; One Life — Expected Return Multiples*. For married residents, use *Table VI — Ordinary Joint Life and Last Survivor Annuities; Two Lives — Expected Return Multiples*. Regulation section 20.2031-7(d)(6) also has annuity valuation tables but only for single persons.[154]

Regarding the discount rate for term loans, section 7872(f)(2)(A) requires using "the applicable Federal rate [for the loan term] in effect under section 1274(d) (as of the day on which the loan was made), compounded semiannually." The applicable federal rate — short-, mid-, or long-term — depends on the actuarial life of the resident, or for a couple, their joint actuarial life. In applying section 1274(d)(1), the federal short-term rate should be used for actuarial lives of three years or less, the mid-term rate for lives from four through nine years, and the long-term rate for lives over nine years, calculated

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The court rejected the IRS's position in T.A.M. 92-46-006 (July 28, 1992). In this ruling, the IRS had required Highland Farms to include the entire amount of the entry fees in income in the year of receipt. Although the ruling concealed the identity of the entity that requested the ruling, it is obvious from the facts presented, which are identical to the findings of fact in the case, that it applied to Highland Farms, Inc. The court stated its rejection in strong terms: "It was an abuse of discretion for [the IRS] to conclude that the fees must be included in [Highland Farms'] income for the year of receipt." *Id.*

154 *See Table S - Based on Life Table 80CNSMT Single Life Remainder Factors Applicable After April 30, 1989*. This table lists the present values of a remainder interest for a single person, depending on the person's age and the required interest rate.

beginning with the effective date of the resident's contract with the CCRC. The applicable rates are listed in revenue rulings issued monthly by the IRS.[155]

If the discounted present value is less than the section 7872(g)(2) exemption amount, currently $134,800,[156] the entrance fee refund is exempt from the below-market-rate loan rules of section 7872. Nothing must be reported to the IRS. If it exceeds the exemption, only the excess portion is subject to the section 7872 rules. Each year, the resident should report as interest income the semi-annual amortization of the original issue discount (OID) according to the section 1272 rules. To determine the OID applicable to the excess portion on which the amortization is based, the OID apparently must be apportioned between the excess amount and the exemption amount, as shown in Example 1 below. No specific statutory or administrative guidance is given with respect to apportioning the OID.

The CCRC must report two items regarding the guaranteed refund: (1) annual interest expense, *i.e.*, the appropriate amount of semi-annual amortization of the OID depending on whether the cash or accrual accounting method is used, and (2) gross receipts income in the year the entrance fee is received, *i.e.*, the OID applicable to the portion in excess of the exemption amount, per section 7872(b)(1), both shown in Example 1 below.

As required under Proposed Regulation section 1.7872-11(g),[157] both the resident and the CCRC should attach a statement to their tax returns which (1) explains that the income (deduction) relates to section 7872, (2) lists the other party, (3) specifies the

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[155] *See*, *e.g.*, Rev. Rul. 98-4, 1998-2 I.R.B. 18. This ruling provides the rates for January 1998.

[156] Rev. Rul. 97-57, 1997-52 I.R.B. 16.

[157] (1985).

amount of the imputed interest income (expense), and (4) specifies the mathematical assumptions.

Although examples of determining the discounted present value of a term loan are given in Proposed Regulation section 1.7872-14(b),[158] none applies to a refundable CCRC entrance fee. Hence, we give two examples. Example 1 shows the effects of discounted and undiscounted guaranteed entrance fee refunds, and Example 2 illustrates the impact of the imputed interest rules on a discounted refund which exceeds the exemption amount.

a. Example 1. On June 1, 1997, Mr. and Mrs. T, ages 78 and 76 respectively, pay a $300,000 entrance fee to a CCRC, 90% of which is refundable on the death of the surviving spouse. Mr. and Mrs. T have made a non-interest-bearing $270,000 loan to the CCRC. Based on their joint actuarial life of 15.0[159] years and the June 1997 applicable federal long-term rate of 6.99% compounded semi-annually,[160] the discounted present value is $96,335. This falls below the 1997 exemption amount of $131,300[161] and is not subject to the section 7872 below-market-rate loan rules. If Mr. and Mrs. T are more conservative, however, and treat the undiscounted $270,000 refund amount as applicable with respect to the exemption, the excess would be $138,700. The discounted present value of this excess amount is $49,487, which is subject to the section 7872 rules. We present the method for calculating the imputed interest and the discount-related income that must be reported in Example 2.

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[158] (1985).

[159] Reg. § 1.72-9 (as amended in 1995), *Table VI — Ordinary Joint Life and Last Survivor Annuities; Two Lives — Expected Return Multiples*.

[160] Rev. Rul. 97-24, 1997-22 I.R.B. 17.

[161] Rev. Rul. 96-64, 1996-2 C.B. 199.

b. Example 2. On June 1, 1997, Mrs. Z, an 83-year-old widow, pays a $300,000 entrance fee to a CCRC, 90% of which is refundable on her death. Her actuarial life is 7.9 years;[162] consequently, the federal mid-term rate of 6.69%, compounded semi-annually,[163] must be used instead of the long-term rate. The discounted present value of the $270,000 non-interest-bearing loan is $160,543. Because this exceeds the $131,300 exemption amount,[164] $29,243, or 18.215% of the total discounted present value, is subject to the section 7872 rules. The total loan discount is $109,457, but because 18.215% of the discounted present value is subject to section 7872,[165] only $19,938 must be recognized by the borrower, the CCRC, as income in 1997 in addition to the $30,000 forfeitable portion of the entrance fee.

As for the imputed interest on the $29,243 in excess of the exemption, the section 1272 OID rules control. Since the interest is compounded semi-annually, the discount must be amortized semi-annually and reported as income at the end of each half year. Therefore, Mrs. Z must report the $978 of amortized discount for the first half year ending December 1, 1997 as income in 1997 ($29,243 x [6.69%/2]). Likewise, the CCRC must deduct $978 of interest expense if it uses the cash basis of accounting; otherwise it must accrue and deduct seven months of interest expense. The $978 in amortized discount will increase Mrs. Z's basis, termed the adjusted issue price, of the loan per section 1272(a)(4), and the CCRC must make the corresponding adjustment on

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[162] Reg. § 1.72-9 (as amended in 1995), *Table V— Ordinary Life Annuities; One Life — Expected Return Multiples*.

[163] Rev. Rul. 96-64, 1996-2 C.B. 199.

[164] Rev. Rul. 97-24, 1997-22 I.R.B. 17.

[165] Although we found no statutory or administrative guidance on how to allocate the discount between the safe harbor portion of a loan's present value and the portion subject to I.R.C. § 7872, we believe our percentage approach is reasonable.

its books. In 1998, the imputed interest would total $2,056: $1,011 on June 1, 1998 ([$29,243 + $978] x [6.69%/2]) and $1,045 on December 1, 1998 ([$29,243 + $978 + $1,011] x [6.69%/2]).

Having advocated that an entrance fee refund is a discountable term loan and having examined the tax impact of the below-market-rate loan rules, we return to discussing medical expense deductibility.

C. How Will an Entrance Fee Refund Affect the Deductible Amount of the Medical Expense Portion of the Entrance Fee?

The answer may depend on whether the refund is guaranteed or not. Since the time this issue was first addressed in 1971 by the IRS's General Counsel,[166] the Service has consistently ruled that a medical expense deduction based on the full entrance fee is allowed in situations where the entrance fee is partially refundable if residence is terminated "under certain circumstances."[167] All of the rulings are based on the presumption that once the resident has lived at the CCRC long enough or has not satisfied the "certain circumstances" specified in the contract at the time of termination, there is no refund. In other words, there is no certainty at the time the entrance fee is paid that any portion will subsequently be refunded. If a refund is received, the previously deducted medical expense portion attributable to the refund should be included in the resident's

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[166] G.C.M. 34,561 (July 26, 1971). *See supra* note 33 and accompanying text.

[167] *See* Rev. Rul. 76-481, 1976-2 C.B. 82; Rev. Rul. 75-302, 1975-2 C.B. 86. *See also* P.L.R. 78-07-093 (Nov. 21, 1977) ("the entrance fee is refundable on a pro-rata basis if the resident withdraws from [the CCRC] within the first y months of residency"); P.L.R. 89-30-024 (Apr. 27, 1989); P.L.R. 84-10-057 (Dec. 6, 1983); P.L.R. 76-08-300510A (Aug. 30, 1976).

gross income in the year received per Regulation section. 1.213-1(g)(1), mitigated by the tax benefit rule of section 111.[168]

In contrast, the IRS and the courts have never specifically addressed the situation when the resident or their estate receives a *guaranteed* refund at termination. In recent years, more residency contracts are being written as such, specifying a guaranteed minimum refundable amount of the entrance fee at termination, ranging from 10% to 100%.[169] Many such contracts prorate the refund from the date of initial residency until either the resident dies or vacates, or a guaranteed base refundable percentage is reached, whichever comes first. One tax commentator has written, "[i]t thus is unclear exactly what effect a refund feature (whether or not that feature includes a penalty) has on the deductibility of prepaid life-care facility entrance fees . . . ."[170] Perhaps because the size of the refund depends on when a resident moves out or dies, the IRS has chosen to allow a medical expense deduction based on the full entrance fee. Also, unless future payment of the entrance fee refund is insured or bonded, residents do not have complete assurance that the CCRC will be able to pay the refund when it becomes due. About three tenths of one percent of CCRCs have declared bankruptcy in the recent past.[171]

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[168] The tax benefit rule allows a taxpayer to limit the amount of a refund includable in gross income to the portion of the original deduction that yielded a tax benefit, *i.e.*, a reduction in tax liability.

For example, in 1995, a 70-year-old CCRC resident with an adjusted gross income (AGI) of $20,000, filing as a single taxpayer paid a $100,000 entrance fee, of which 10% or $10,000 was medically related. If the resident had no other itemized deductions, the portion of the $10,000 medical expense that yielded a tax benefit was $3,650 ($10,000 less 7-1/2% of the $20,000 AGI or $1,500 less the $4,850 standard deduction). If the resident moves out in 1997 and receives a 60% refund of the entrance fee, the medical expense attributable to the refund would be $6,000. Because the resident only received a tax benefit of $3,650 on the deduction in 1995, only $3,650 must be included in gross income for 1997. This would be reported on Line 21 on Form 1040, and may be calculated using Table 5 in IRS Publication 525.

[169] Some CCRCs do not specify the guaranteed refundable percentage *a priori*, leaving it open to negotiation with the resident.

[170] The Research Institute of America, Inc., Fed. Tax Coord., 2d K 2403 (RIA) (1997).

[171] Christopher J. Conover and Frank A. Sloan, *Bankruptcy Risk and State Regulation of Continuing Care Retirement Communities*, 32 Inquiry 444 (Winter 1995/1996).

Due to the lack of direction from the IRS and the courts as to which entrance fee amount CCRCs and residents should use in calculating a resident's medical expense deduction where a portion of the entrance fee is guaranteed refundable, we consider three possible amounts in the sections below: (1) the entire entrance fee regardless of the guaranteed refund, (2) the entrance fee less the face (full) amount of the guaranteed refund, and (3) the entrance fee less the discounted present value of the guaranteed refund.

These amounts may be used whether a CCRC allocates its medical costs to its residents as a percentage of their entrance fees or on a per capita basis. Although the IRS has only ruled on refund situations where CCRCs specified the medical expense portion of an entrance fee as a percentage,[172] the Service,[173] as do we, recommends calculating the medical portion of an entrance fee on a per capita basis, *i.e.*, the same lump sum amount for each resident irrespective of the cost of their residential units. We describe the rationale for the per capita approach in more depth in section IV.C.1.b.

Ideally, the amount of a resident's medical expense deduction should be unaffected by a CCRC's selection of a fee amount since the numerator — the CCRC's total medical costs — would be the same. The size of the denominator — whether the full entrance fee, the entrance fee less the guaranteed refund, or the entrance fee less the discounted guaranteed refund — would differ, and thus the deductible medical expense percentage that the CCRC reports to its residents would also differ. But when the resident multiplies the CCRC's percentage by the relevant amount of their entrance fee,

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[172] *See supra* not 167.

[173] *See* P. L. R. 86-51-028 (Sept. 19, 1986) and P. L. R. 86-30-005 (Apr. 4, 1986). Recently, an IRS representative informed the American Association of Homes and Services for the Aging (AAHSA) that the percentage "methodology of calculating the medical deduction is seriously flawed and should be changed. Rather, resident medical deductions should be allocated on a per capita basis." Gordon, *supra* note 70.

the medical expense deduction would end up being the same regardless of the amount used.[174] Ergo, it should be irrelevant which fee amount a CCRC chooses as long as it is consistent in informing the residents as to their deductible medical expense percentage and the relevant entrance fee amount for the computation. Similarly, the choice of entrance fee amount should not affect residents' medical expense deductions under the per capita approach.

Realistically, however, CCRCs may not be consistent in advising their residents as to the proper medical expense portion of the entrance fee. For example, they may have allocated some of the medical costs to the refund portion of the fee while informing residents that they can only deduct the medical expenses associated with the non-refundable portion. Because CCRCs fund medical costs out of the forfeitable (non-refundable) portion of an entrance fee as well as out of the imputed interest saved on the non-interest-bearing refundable portion, no medical costs should be allocated to the refund.

In any case, it behooves residents, who bear the burden of proof, to use the appropriate entrance fee amount as discussed below for figuring their medical expense deduction. Although the full fee may serve some CCRC residents best, it is flawed because medical expenses are attributable to the loan portion of the fee. The second choice is also flawed because it treats the refund as a demand loan rather than as a term

[174] For example, a CCRC determines that its medical costs were $1,200,000. It collected $8,000,000 in entrance fees, $4,000,000 of which are guaranteed refundable. The discounted present value of the guaranteed refundable portion is $2,000,000. Therefore, the denominators are $8,000,000, $4,000,000, and $6,000,000, and the medical deduction percentages are 15%, 30%, and 20% respectively.

The resident then multiplies the percentage by the relevant portion of their entrance fee as determined by the fee amount selected by the CCRC. If the resident had paid a $120,000 entrance fee, half of which is guaranteed refundable, the resident would be advised by the CCRC to multiply the relevant portion of their entrance fee by the percentage. Therefore, the resident will have a deductible medical expense of $18,000 ($120,000 x 15%) using the full fee, $18,000 ($60,000 x 30%) using the fee less the face amount of the guaranteed refund, and $18,000 ($90,000 x 20%) using the third choice assuming that $90,000 is the entrance fee less the discounted present value of the guaranteed refund.

loan and therefore is at odds with section 7872. We recommend the third choice both for CCRCs and their residents.

1. Calculating the medical deduction on the full entrance fee. This is an attractive choice because it may yield the largest tax savings if the CCRC has been inconsistent in calculating the percentage. It also the most aggressive choice, but it has a major flaw. The guaranteed refund is classified as a below-market-rate loan per section 7872 as discussed previously in section III.B.[175] Loans are not expenses and as such are not deductible. Hence, any medical expenses allocable to the guaranteed refund portion of the entrance fee would not be deductible. We believe the IRS may take the position that the guaranteed refund is a loan and will deny that portion of the medical expense deduction.[176]

Still, we would not discourage a resident from using the full entrance fee for three reasons: (1) the Service's rulings that mention entrance fee refunds allow taking the medical deduction on the full entrance fee and require that the medical expenses associated with any subsequent refund be taken back into taxable income in the year received,[177] (2) these rulings do not specifically proscribe taking a deduction on the full entrance fee when there is a guaranteed refundable portion, and (3) the rulings say

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[175] Although I.R.C. § 7872 does not apply to any below-market loan made by a resident to a qualified continuing care facility less than the inflation-indexed exemption amount (*see* I.R.C. § 7872(g)(1)), it nonetheless classifies the refundable portion of an entrance fee as a loan. Regarding the exemption amount of $134,800 in 1998, see Rev. Rul. 97-57, 1997-52 I.R.B. 16.

[176] In the event that the IRS should do so, we believe that the rulings cited in section II.B.1 *supra* that allow deduction on the full entrance fee, should be sufficient to satisfy the substantial authority requirements of Reg. § 1.6662-4(d)(iii) (as amended in 1995). As elaborated in section III.B.3.c. *supra*, this statute specifies the penalty for taking an aggressive tax return position contrary to the IRS's views. We recommend that such residents avail themselves of the safe harbor by attaching Form 8275 (Disclosure Statement) to the return (*see* Reg. § 1.6662-4(f)(1), (2) (as amended in 1995)) and adequately disclosing the nature of the medical expense deduction.

Furthermore, the resident could take the position that the medical expense portion of the entrance fee is not spread over the entire fee but only relates to the non-refundable portion.

[177] *See* Rev. Rul. 76-481, 1976-2 C.B. 82; Rev. Rul. 75-303, 1975-2 C.B. 87; Rev. Rul. 75-302, 1975-2 C.B. 86. *See also, e.g.,* P.L.R. 89-30-024 (Apr. 27, 1989); P.L.R.87-48-026 (Aug. 31, 1987); P.L.R. 86-30-005 (Apr. 4, 1986); and P.L.R. 84-10-057 (Dec. 6, 1983).

nothing about having to deduct only the medical expenses allocable to the net entrance fee, *i.e.*, the entrance fee net of the guaranteed refund amount. We recommend that only those residents (or their children if their children are paying the fees and claiming their parents as dependents) whose adjusted gross income is large enough to give them a significant tax benefit from the deduction use the full entrance fee.[178] The time value of money makes it worthwhile for residents to take the medical expense deduction on the full fee in the year paid and then wait to repay the taxes associated with the refund. In fact, no subsequent taxes may have to be paid, as explained next.

a. When the resident vacates or dies: Recapture of the previously deducted medical expenses attributed to the refund on the resident's, estate's, or heirs' taxable income. If a resident deducts medical expenses based on the full fee and later moves out of the CCRC, they must include the medical expenses allocable to the refunded portion of the entrance fee in their gross income in the year received,[179] subject to the tax benefit rule under section 111.

But if the resident dies, there is no income tax effect! None of the previously deducted medical expenses attributable to the refund will have to be included in either the resident's, their estate's, or their heirs' gross income. Because the refund will be paid to the resident's estate or other beneficiary rather than the resident at the time of death,[180] the medical expense portion of the refund is not income in respect of the decedent per

[178] If a resident's entrance fee medical expense deduction is expected to be close to or exceed their adjusted gross income, they perhaps could negotiate payment of the fee in two installments split between tax years.

[179] Rev. Rul. 76-481, 1976-2 C.B. 82; Rev. Rul. 75-303, 1975-2 C.B. 87; Rev. Rul. 75-302, 1975-2 C.B. 86.

[180] CCRC contracts normally provide that the refund will be paid to a resident's estate or revocable trust.

section 691. Nonetheless, the refund must be included in the resident's gross estate and may incur estate tax.[181]

2. Calculating the medical deduction on the entrance fee less the face amount of the refund. This choice involves deducting only the medical expenses allocable to the entrance fee less the full or undiscounted value of the guaranteed refundable portion. It is the most conservative of the three and may yield the lowest medical expense deduction depending on how the CCRC calculates the percentage. We do not recommend it because it treats the refundable portion as a non-discountable demand loan rather than as a term loan. There is no basis for this under our interpretation of section 7872 and the proposed regulations.[182] Therefore, the third choice is superior to this one in theory and perhaps in the size of the permitted medical deduction.[183] If a CCRC reports the entrance fee to its residents in this fashion, we recommend that the residents recompute the amount by discounting the refund as specified in section III.B. This is what we did for Mrs. W in the section I.B. example.

a. When the resident vacates or dies: Recapture of the previously deducted medical expenses attributed to the refund on the resident's, estate's, or heirs' taxable income. Opting to deduct medical expenses based on the entrance fee refund, discounted or not, however, could result in including some of the medical expenses in gross income in the year the refund is received. When an entrance fee is

[181] One strategy to avoid estate tax might be to donate the right to the refund to a charity if the resident's contract with the CCRC permits it. Gifting it to one's children or other recipients in $10,000 segments will not qualify for the $10,000 annual gift exclusion because it is a gift of a future interest. *See* I.R.C. § 2503(b).

[182] Prop. Reg. § 1-7872 (1985).

[183] This may not be an issue, however, if the CCRC advises its residents that medical costs are only associated with the non-refundable portion of the entrance fee. Nonetheless, we believe that the residents could still make a case for the third method because the CCRC is undoubtedly using the money it saves by not having to pay interest on the refund to cover some medical costs.

refundable on a pro-rata basis based on length of residency, premature termination will result in a higher refund than the guaranteed minimum. If the resident moves out, the medical expense portion allocable to the difference between the guaranteed minimum refund and the actual refund must be included in the resident's gross income in the year received per Regulation section 1.213-1(g)(1), subject to the tax benefit rule of section 111. If the resident dies, however, none of the difference will have to be included in either the resident's, estate's, or heirs' taxable income because, as mentioned in section III.C.2.a. above, it is not income in respect of the decedent.

3. Calculating the medical deduction on the entrance fee less the discounted present value of the refund. We recommend this as the safest choice. The medical expenses allocable to the entrance fee are figured only on the fee net of the discounted present value of the guaranteed refundable portion. This makes sense economically as previously mentioned because CCRCs fund medical costs out of the forfeitable (non-refundable) portion of an entrance fee as well as out of the imputed interest saved on the non-interest-bearing refundable portion.[184] By treating the refundable portion as a term loan, the discounted present value of the refund may be less than half of the face value for most residents.[185] This choice will yield a larger deduction than the second choice if the CCRC inappropriately allocated some of the medical costs to the refund because the refund amount is smaller when discounted.

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[184] In addition, as explained in section III.B.3. *supra*, the imputed interest is calculated on the discounted present value of the refund rather than on the face amount, resulting in a lower reportable amount.

[185] This may be calculated using the exemption amount specified in Rev. Rul. 97-57, 1997-52 I.R.B. 16 and using the discount rates listed in Rev. Rul. 98-4, 1998-2 I.R.B. 18. *See* discussion *supra* section III.B.2.

Nevertheless, the size of a resident's medical expense deduction may be more affected by a CCRC's medical expense allocation method than by the choice of fee just discussed. Next we explore and recommend how a CCRC should make the allocation.

IV. Determining the Fee Percentage Allocable to Medical Expenses

A. Introduction

CCRCs typically determine the medical expense portion of their operating expenses either of two ways: (1) the expense category approach which entails analyzing each expense account category for the medical expense portion, or (2) the actuarial method which involves estimating the average annual medical expense per resident based on actuarial information about the CCRC's resident population.[186] However, no industry-wide consistency exists under either method for apportioning the medical expenses between the entrance fee and the monthly fees.

Residents have an important stake in the cost allocation method used by CCRCs to calculate the medical expense deduction. Even though the computation does not directly benefit the CCRCs, it may have considerable impact on the tax liabilities of their residents. By not spending enough time on the calculation or by applying an inappropriate method, the CCRCs could be costing their residents thousands of dollars in tax savings. Most residents will not realize whether they are being advised correctly since they generally are unaware of the mechanics of the CCRCs' computations. While it

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[186] A third method — a market rent comparison — could be used by fee-for-service CCRCs that do not require an entrance fee. The difference between the monthly fees charged by the CCRC and the monthly rent of an equivalent apartment, adjusted for the value of any additional, non-medical CCRC services, would presumably reveal the medical expense portion of the monthly fees.

is the residents' duty to become better informed, we believe that CCRCs, also, have a fiduciary responsibility to help their residents get the greatest and most accurate deduction possible.

In the next section we examine the views of the IRS and courts regarding CCRCs' calculation of the medical expense allocation. In section C we discuss the two calculation methods currently in practice along with the theoretical aspects of the allocation and conclude with what we believe is a consistent and rigorous approach for calculating the allocation.

B. What Statutory Law, Case Law, and the IRS Say Regarding Allocation

Both statutory law and case law are silent regarding methods for calculating the medical expense fee allocation,[187] and the IRS has given little guidance. Although the Service has said that the medical expense percentage used by a CCRC is appropriate if based on either the CCRC's prior experience[188] or the long-term operating experience of a comparable CCRC,[189] it has issued no pronouncement of precedential value with respect to the mechanics of cost allocation.

In private letter rulings, however, the IRS has gone farther with the issue; beginning in 1976, the Service issued a ruling stating that a CCRC's "prior financial

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[187] Sections 321 and 322 of the Health Insurance Portability and Accountability Act of 1996 give no guidance regarding allocation. Christopher has suggested otherwise:

> It appears that the new test for determining the degree to which CCRC and life-care contracts will be deductible will be governed by the historical budget for caring for persons in the facility's census who are unable to perform two of the six ADLs or who otherwise meet the definitional test of 'chronically ill.'

Christopher, *supra* note , at 22. We find no evidence to support this opinion. The Act is silent with respect to an allocation method.

[188] *See* Rev. Rul. 75-302, 1975-2 C.B. 86 (allowing a 30% allocation).

[189] *See* Rev. Rul. 76-481, 1976-2 C.B. 82 (allowing a 15% allocation of the monthly fees and a 10% allocation of the entrance fee). *See also Estate of Smith*, 79 T.C. 313, *acq.*, *action on decision* 1984-051 (July 16, 1984) (allowing a 7% medical expense allocation, with no mention of the calculation method used by the CCRC).

experience is a reasonable method to determine the [allocation]."[190] Rulings in the 1980's began to give some indication as to the Service's thoughts on the mechanics of an appropriate allocation method.[191] In the early 1980's, the rulings suggest dividing the CCRCs' "directly related medical expenses by total expenses" to find the percentage that would then be used to calculate the medical portion of the entrance and monthly fees.[192] While the Service suggested this method, it refused to give an opinion as to what constitutes an appropriate percentage.[193] Items considered by the rulings as medical expenses in this calculation included, among others: nursing salaries, maintenance utilities, interest on indebtedness, housekeeping, real estate taxes, depreciation, administrative costs, and marketing costs.[194]

In the mid-1980's, the Service began questioning whether residents with different sized units costing different amounts should be able to deduct different medical costs. The IRS ruled that residents of the same CCRC should be put on an "equal footing"[195] using a "weighted average" to achieve a "proper allocation" of medical expenses.[196] In 1989, the IRS ceased issuing rulings on the issue altogether after stating that "[t]he Service has no published position regarding the method of allocation . . . , there is no basis to favor one method of allocation over another . . . , [and] [b]ecause this issue is

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[190] P.L.R. 76-08-300510A (Aug. 30, 1976).

[191] *See* P.L.R. 86-51-028 (Sept. 19, 1986); P.L.R. 86-41-037 (July 11, 1986); P.L.R. 86-30-005 (Apr. 4, 1986); P.L.R. 82-13-102 (Dec. 30, 1981).

[192] P.L.R. 82-13-102 (Dec. 30, 1981).

[193] *Id*.

[194] P.L.R. 86-51-028 (Sept. 19, 1986); P.L.R. 86-41-037 (July 11, 1986); P.L.R. 86-30-005 (Apr. 4, 1986).

[195] *See, e.g.,* P.L.R. 86-30-005 (Apr. 4, 1986).

[196] *See*, *e.g.*, P.L.R. 86-51-028 (Sept. 19, 1986).

currently under study, no opinion is expressed."[197] Thus, CCRCs continue to have little guidance and consequently have considerable latitude in selecting an allocation method.

C. Critique of Medical Expense Allocation Methods

1. Expense category method – issues and recommendations. Under this method each expense category is analyzed to estimate what portion of each category's total costs are for medical purposes. The CCRC adds up the estimates and divides the total by the total expenses of the facility to determine the medical expense allocation percentage as shown in Table 1 in section IV.C.1.c. below. Residents then use this percentage to compute the deductible amount of their monthly fees paid in that year. Typically, CCRCs advise new residents to use this same percentage to calculate the deductible portion of their entrance fee paid in their first year of residence. According to conversations we had in early 1995 with CCRCs using this method, they do not invest much time in analyzing their medical expenses. Their main concern is to make sure that the percentage seems reasonable to the IRS.

In the following five sections, we make recommendations regarding shortcomings in the way CCRCs typically implement the expense category method.

a. Estimate the medical expense portion accurately. The medical expense percentage is only as accurate as the estimates of the medical costs per expense category. CCRCs, at least the ones with whom we spoke, tend to guesstimate each

[197] P.L.R. 89-30-024 (Apr. 27, 1989). The IRS has not changed its position since this ruling. The IRS is not interested in issuing opinions regarding what constitutes a proper allocation method or amount. An IRS official stated that "the IRS believes that the CCRC is most capable of calculating an accurate amount and that our main concern is that the amount is reasonable." Interview with IRS official (Jan. 15, 1998; Feb. 3, 1995).

category's percentage rather than analyzing the additional costs in each category that result from providing for the actual and preventative medical needs of the residents.

The medical proportion of these categories is subjective, and the residents or their CPAs may question or challenge it. The residents, rather than the CCRCs, bear the burden of proof if questioned by the IRS. Using the CCRC's data, residents may make their own reasonable approximations even though they differ from those of the CCRC. We did this for Mrs.W in amending her return (see section I.B.). Her CCRC initially estimated the deductible allocation percentage for food service expense and activities expense at 2.5% and 25% respectively. We raised them to 10% and 50%. As for food, we believed that 2.5% (about $30,000 out of $1.2 million) was far too small given the salary of a qualified dietician and the costs of providing and preparing foods for the dietary and health prevention needs of the residents. Regarding the activities expense, we believed well over 50% could have a medical connection based on the therapeutic mental and physical benefits, but settled on 50%.

b. Assign each resident the same medical deduction amount irrespective of the size of their fees - the per capita approach. CCRCs typically assign all of their residents the same percentage to multiply by their entrance and monthly fees to determine their medical expense deduction. Residents with larger units get a larger medical expense deduction because they pay higher fees. This is unreasonable to us because it is unlikely that a relationship exists between a resident's health and their unit size. Medical costs depend on the number of residents, not the unit size and cost.[198]

[198] Although it could be argued that younger residents should get a larger deduction because their total expected medical costs should be higher than those of older residents, the medical portion of the fee is a type of medical insurance as was explained *supra* section II.B.4 and as such may be borne equally by all the residents.

The IRS has also recommended that residents with different sized units and fee payments should be put on an "equal footing."[199]

Rather than specifying a percentage, CCRCs should tell each resident their per capita dollar share of the facility's total expenses applicable to their monthly and entrance fees paid during that year. To find the per capita medical expense deduction per resident, the medical expense allocation percentage (as determined using the direct cost method explained in the next section) must be multiplied by the total annual fee revenue for the CCRC and then be divided by the number of residents. (We did not compute Mrs. W's medical expense deduction in this fashion in the section I.B. example because we could not get a resident count for the year at issue.) We recommend calculating the per capita amounts for monthly and entrance fees using the direct-cost approach as explained next.

c. Use direct costs, not total costs, in calculating the medical expense portion. The medically related percentage of a CCRC's operating expenses ought to be figured using a CCRC's direct operating costs rather than the total operating costs as is customarily done. Direct costs directly affect the residents, *e.g.*, food services, housekeeping, utilities, front desk, security, and health services.[200] Other costs like depreciation, administration, interest, real estate taxes, and marketing are indirect overhead or support costs because they do not directly affect the residents.[201]

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[199] P.L.R. 86-51-028 (Sept. 19, 1986); P.L.R. 86-30-005 (Apr. 4, 1986). *See also supra* text accompanying note 173; *infra* note 210.

[200] *See also* Charles T. Horngren et al., *Cost Accounting: A Managerial Emphasis* 27 (9th ed. 1997) ("Direct costs of a cost object [the CCRC residents] are costs that are related to the particular cost object and that can be traced [allocated] to it in an economically feasible (cost-effective) way.").

[201] *Id.* "Indirect costs of a cost object are costs related to the particular cost object but cannot be traced to it in an economically feasible (cost-effective) way." *Id.*

Classifying costs as direct and indirect with respect to the residents makes more sense from a cost accounting standpoint,[202] and this method will benefit residents by increasing the percentage deduction. Similar to computing a manufacturer's overhead or indirect cost allocation rate based on a direct-cost activity measure such as direct labor hours, the medical cost allocation rate should be calculated using the annual direct operating costs of the CCRC.[203] For monthly fees, this percentage rate may be computed as the weighted average of the medical expenses from each direct cost category for the calendar year (*see* Table 1 below). The percentage may then be multiplied by the total monthly fee revenues collected from residents for that year to find the total medical costs allocable to monthly fee revenue for the CCRC.[204] This total may in turn be divided by the number of residents to determine the medical expense deduction associated with each resident's monthly fees for that year. As discussed in section IV.C.1.e.(1). below, we recommend that only the ILU-related medical costs be figured in calculating the monthly fee medical allocation. For entrance fees, we recommend using projected, rather than the past year's, direct costs for the entire facility, not just the ILUs, as discussed in section IV.C.1.e.(2). below.

As may be seen from the sample data in Table 1, use of direct costs rather than total costs nearly doubles the medical expense allocation percentage from 10.89% to

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[202] Classifying costs as direct and indirect is well established in the judicial law and federal regulations. *See*, *e.g.*, *United States v. R. W. Meyer, Inc.*, 889 F.2d 1497, 1504 (6th Cir. 1989), *cert. denied* 494 U.S. 1057 (1990) ("The use of direct and indirect costs in calculating total cost comports with standard accounting practices . . . ."); *Life Ins. Co. of Georgia v. United States*, 16 Ct. Cl. 359, 362 (1989) ("To the extent it is economically feasible to do so, costs should be distributed pursuant to the causal relationship between the resource consumed and the benefiting objective.") (citing Allocation of Direct and Indirect Costs, 4 C.F.R. § 418.50(e) (1988)).

[203] Using the percentage determined from the direct cost categories, the indirect or support costs are effectively allocated or split between two cost categories: residents' medical and non-medical expenses.

[204] To determine the medical deduction associated with each resident's monthly fees, we recommend multiplying the direct cost allocation percentage by the total fee revenues collected by the CCRC for the year rather than by the CCRC's total costs, because the fee revenues represent the total costs incurred by the residents. For profit-making CCRCs, the fee revenues include a profit factor which, for the residents, is an additional overhead or indirect cost.

19.13%. If a CCRC is unwilling or unable to provide residents with a direct cost analysis, we encourage the residents or their CPAs to rework the CCRC's expense analysis accordingly. We provided this analysis to Mrs. W, as discussed in section I.B.

TABLE 1

Total-Cost and Direct-Cost Analysis of a Sample CCRC's Annual Operating Expenses for Determining the Medical Expense Allocation Percentage[205]

Expense Category	Actual Annual Cost	Medical Allocation %	Medical Allocation Amount	Weighted Average Medical Allocation %
Direct Costs:				
Front Desk/Security	$ 147,237	50%	$ 73,619	
Resident Transportation	55,498	50%	27,749	
Resident Activities	53,405	50%	26,703	
Misc. Resident Services	75,373	75%	56,530	
Health Services	151,124	100%	151,124	
Food Service	1,175,590	10%	117,559	
Housekeeping	271,415	10%	27,142	
Laundry	18,533	5%	927	
Utilities & Resident Units	769,673	5%	38,484	Direct Costs
Sub-Total (Direct Costs)	$ 2,717,848		$519,837	19.13%
Indirect/Overhead Costs:				
Marketing	$ 263,581	0%	$ 0	
Accounting	197,956	15%	29,693	
Employee Services	47,118	5%	2,356	
Administrative	426,028	15%	63,904	
Financial Interest	373,938	5%	18,697	
Building & Grounds	538,101	5%	26,906	
Depreciation	1,511,145	0%	0	
Sub-Total (Indirect Costs)	$3,357,867		$141,556	
Total Operating Expenses	$6,075,715		$661,393	Total Costs 10.89%

d. Give a higher monthly fee deduction to residents of assisted living units, (ALUs) and nursing care units than independent living units (ILUs). For most residents, we believe that ALU monthly fees should be 100% deductible as medical care, as discussed in section II.B.3.b. CCRCs that assign the same percentage to both ALU and ILU residents are overstating the ILU percentage and understating the ALU percentage. Other CCRCs merely report a higher medical care percentage for ALU residents, but far less than 100%, apparently concluding that their ALU residents are not sufficiently chronically ill to warrant deducting 100% of the costs. For example, one

[205] The data were taken from a CCRC's income statement from the early 1990's.

CCRC that has done so advised its residents that 13% of their ILU monthly fees and 37% of their ALU monthly fees, rather than 100%, were for medical care in that particular year.[206]

For those ALU residents who do not have enough ADLs[207] to qualify as "chronically ill," and thus are not eligible for a 100% monthly fee deduction, the additional annual personal care costs may be accounted for separately by the CCRC. The total of these costs should be divided by the number of non-chronically ill ALU residents, and the resulting amount may be added onto the per capita ILU medical expense amount already calculated for ILU residents using the steps recommended in the section above.

CCRCs need to keep track of their ALU and nursing care expenses separately so as not to inflate the ILU medical deduction. This is a cost classification issue which is particularly important for those CCRCs that offer extensive-care contracts and also accept private pay ALU or nursing care residents.

e. Calculate the medical expense portion of monthly fees using a different method than for entrance fees. Different methods of calculating the tax deductible portion of monthly and entrance fees ought to be used because of the differing rationales for charging each fee. Based on conversations conducted with CCRC administrators in early 1995, entrance fees typically are intended to provide long-term capital for CCRC facilities, whereas monthly fees cover the ongoing operating expenses. There is little basis for applying the same medical allocation percentage to both the monthly and entrance fees other than for convenience or for mature CCRCs whose

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[206] Information supplied by a Florida CCRC.

[207] *See* discussion of the Health Insurance Portability and Accountability Act of 1996 *supra* section II.B.3.b.

medical expense percentage remains fairly steady over the years.[208]

(1). Monthly fees. Because monthly fees for chronically ill ALU residents and nursing care residents are fully deductible medical expenses, we recommend including only those expenses for ILU residents' medical needs in the calculation of the monthly fee medical allocation. Using the ILU-related medical costs from each particular year's operating data, the per capita medical allocation for that year's monthly fees may be calculated by the CCRC as described in section IV.C.1.c. above. The contract type, whether extensive, modified or fee-for-service, would not affect this calculation because all three treat ILU residents the same with respect to monthly fees. For monthly fees paid by non-chronically ill ALU residents, see section IV.C.1.d. above.

(2). Entrance fees. We recommend that CCRCs use their projected future costs rather than the past year's costs to compute the per capita medical expense portion of entrance fees using the following six steps. For the cohort of new residents entering the CCRC during a year, (1) calculate the expected number of years of residency (usually the actuarial life) for each resident entering in that year, (2) find the average of step 1 for the cohort, (3) compute the CCRC's projected medical expense percentage for each of the years up through the year computed in step 2 by dividing each future year's projected medical cost by the projected operating costs as explained in section IV.C.1.(c) *supra*,[209] (4) find the multi-year average of step 3, (5) multiply the average medical expense percentage in step 4 by the sum of the entrance fees paid by the

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[208] The IRS has permitted deducting different medical expense percentages for monthly and entrance fees. In Rev. Rul. 76-481, 1976-2 C.B. 82, 15% and 10% respectively of the fees were deductible.

[209] The projected costs do not need to be discounted because both the numerator and denominator are similarly affected by the time value of money.

cohort, and (6) divide step 5 by the number of new residents in the cohort to determine their per capita entrance fee medical deduction.[210] Steps 1, 3, and 5 bear further explanation as follows.

Step 1: Calculate the expected number of years of residency for each resident. Because the entrance fee provides benefits over one's entire residency, it makes better sense using the expected average medical cost over the entire residency in calculating the per capita medical deduction for each new resident rather than using the medical cost for the year in which the entrance fee is paid. In fact, using the entry year's medical cost may substantially understate the portion of the entrance fee that is for medical care if the CCRC is in its early years of operation. Residents of newer CCRCs generally are younger and require less medical care. Also, for extensive care contracts, using the current year's medical cost will significantly understate the medical portion if all the medical costs of ALU and nursing care residents are not averaged into the calculation. Many residents will eventually require assisted living and nursing care, both of which are generally 100% deductible. For modified contracts, the only items included should be the projected ALU and nursing care costs for the allowable grace period of care, which are received at no additional cost to the residents. Fee-for-service contracts should have the smallest entrance fee medical cost portion because only the projected ILU medical costs would be included.

Step 3: Compute the CCRC's projected medical expense percentage for each of the years by dividing each future year's projected medical cost by the projected

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[210] This is essentially the same as the method recommended by an IRS representative in discussions with the American Association of Homes and Services for the Aging. A CCRC "should calculate the total amount of entrance fees needed to be reserved for prepaid medical expenses, divide the total by the number of residents whose fees are being sit aside, and share that number with residents." Gordon, *supra* notes 70 and 173.

The IRS representative also suggested that, "It is probably permissible to determine the specific amount needed for each person based upon his or her individual actuarial attributes, such as morbidity and mortality." *Id.*

direct operating costs. In contrast to the monthly fee medical cost calculation, the projected medical costs should include ALU and nursing care expenses (100% of them) associated with extensive contracts and modified-contract grace periods.[211] This is because entrance fees include a blend of projected ILU, ALU, and nursing care expenses at such CCRCs. The projections, however, should exclude projected medical costs and operating expenses for ALU and nursing care services provided to three categories of residents: fee-for-service residents, modified-contract residents who are past the grace period, and private pay residents. Also, the projected medical and direct operating costs need not be discounted back to the present because both the numerator and the denominator are similarly affected by the time value of money.

We suggest three options for estimating the expected average medical expense percentage for each year's new-resident cohort: (1) projected historical trend, (2) comparable CCRC experience, and (3) actuarial projection (which we recommend).

First, if the CCRC has been in existence for three or more years, the previous years' trend of medical cost percentages including ALU and nursing unit medical costs may be projected into the future arithmetically or using a time-series regression (performable on many hand-held calculators) for the expected average period of residency of the cohort. We used the historical trend method along with time-series regression to estimate Mrs. W's entrance fee medical expense deduction in the section I.B. example.

Second, if the CCRC has been in existence for less than three years, data from a comparable CCRC may be used to calculate the expected average medical expense

[211] Grace periods for assisted living and nursing care under modified contracts usually range from 10 to 90 days, after which a resident must pay the full monthly cost rather than continuing to pay at the ILU monthly rate.

percentage. The IRS consented to this approach in Revenue Ruling 76-481.[212] Many of today's CCRCs are part of chains that likely have comparable data. A sister CCRC ought to be comparable on several factors — overall size, resident unit cost, and resident demographics (the older the residents, the higher the medical cost percentage, all other things equal).

Third, regardless of the CCRC's age, data from the CCRC's actuarial feasibility study and its subsequent updates may be used. Actuarial studies typically contain data on the projected medical costs of the CCRC over an extended time period and include the additional medical costs of assisted living and nursing care for extensive and modified contracts. CCRCs' actuarial consultants should factor the expected medical costs into the size of the entrance fee. From these data it should be possible to calculate the deductible medical portion of the net entrance fee. We recommend this approach and discuss it in more depth in section IV.C.2.

Step 5: Multiply the average medical expense percentage by the sum of the entrance fees paid by the cohort. We recommend multiplying the average medical expense percentage by the sum of the *net* entrance fees, *i.e.*, the entrance fees less the discounted present value of any guaranteed refunds, as explained in sections III.B.3.c. and III.C., to determine the projected total as medical expense, from which the per capita medical deduction may be computed. As we explain in section III.C., a CCRC may assert that the per capita entrance fee medical expense is fully deductible because it is paid out of the net entrance fee, not the refundable portion.

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[212] 1976-2 C.B. 82.

If a CCRC prefers advising its residents of the deductible percentage rather than the per capita deductible amount, it should use the percentage estimated in step 4 and should inform the residents of the appropriate entrance fee amount to use in multiplying by the average medical expense percentage. Again, we recommend using the net entrance fee, *i.e.*, the entrance fee less the discounted present value of any guaranteed refund. We used the percentage approach in conjunction with the net entrance fee for Mrs. W in the section I.B. example because we did not have the entrance fee and resident count data needed to calculate the per capita amount.

2. Actuarial method – discussion and recommendations. The second approach used in practice involves applying an actuarially-based financial projection model to estimate future medical costs for existing CCRCs or CCRCs in the planning stage. Because CCRCs often base entrance and monthly fees on the results of an actuarially-based feasibility study, completed at the time the facility is being planned, it makes sense to derive the medical cost portion of the fees from the data in the study. Using expected mortality and morbidity (illness) rates based on the gender and age characteristics of the CCRC's current or anticipated residency population, an actuarial firm computes the total projected medical costs. This total, less the residents' expected medical services payments, is discounted back to the current year and divided by the number of residents to find the expected future health cost per resident. The discount rate should include only the expected inflation rate and not an interest factor because entrance fees are non-interest-bearing.

At present, the typical CCRC arbitrarily decides how to divide this total between the monthly and entrance fees. In some cases, CCRC marketing departments have already told prospective residents what portion of the entrance fee is deductible, and, in those cases, the remaining portion is allocated to the monthly fee.[213] Arbitrary allocation is not based on cause and effect, it runs the risk of IRS sanction, and it may hurt some residents to the benefit of others.[214] Nonetheless, in those cases where the marketing department has already advised prospective residents as to the size of the entrance fee medical deduction, the practical solution is to assign the remainder of the total to the monthly fees.

a. Use the actuarial method to compute the entrance fee medical expense portion and use the expense category method for monthly fees. There should be a sound rationale for allocating medical costs between the monthly and entrance fees. Because entrance fees provide CCRCs with long-term capital, and monthly fees cover the operating expenses, we recommend determination of the medical costs using two different methods — the expense category analysis for monthly fees and the actuarial method for entrance fees.[215] The expense category method for monthly fees is consistent with section 213 which permits a medical deduction for those expenses paid in the year.[216] The actuarial method for entrance fees is consistent with *Estate of Smith* which

[213] Interview with Kathleen Harris, A.V. Powell & Associates, Inc., in Chesterfield, Missouri (Apr. 24, 1995). In performing actuarial studies for several CCRCs in the country, A.V. Powell & Associates, Inc. calculates the costs using their financial and statistical database containing actual expense patterns over the past 10 years. *Id*.

[214] Under the fee structure at many CCRCs, singles subsidize couples. CCRCs have designed this purposely to encourage residence by more couples. *Id*. (Jan. 21, 1998).

[215] The actuarial method would not apply to fee-for-service CCRCs where an entrance fee pays for physical occupancy of a unit rather than a guarantee of subsequent medical care.

[216] This assumes that the residents are cash-basis taxpayers which in fact almost all are.

held that payments for future medical care are deductible in the year paid only if the CCRC is contractually obligated to provide the future care to the resident.[217]

For estimating the medical portion of an entrance fee, the actuarial method is better than the historical trend method. Whereas the latter method estimates the medical portion from the average of the projected trend of medical costs obtained using the expense category method, the actuarial method draws on the actuarial estimate of the CCRCs' long-term future medical costs. Just as insurance premiums reflect the actuarial estimate of future costs, CCRCs' entrance fees include an estimate of the future medical costs. The actuarial method is probably more defensible than historical trend analysis in the event of an IRS challenge because it is usually based on years of proven historical data that have been accumulated across a large number of CCRCs by an actuary specializing in the industry.

Although one drawback is the expense of an actuarial study, many CCRCs may already have the data readily available. Generally, before building a CCRC, a feasibility study must be completed. Such a study, which may have been done by an actuarial firm,[218] will project all of the expected future costs in operating a CCRC, including the costs of providing health care to the residents. By using these medical cost projections as adjusted per the suggestions in section IV.C.1.e.(2)., a CCRC may reasonably estimate the deductible medical expense portion of the entrance fee for the initial cohort of residents and update the actuarial projections for subsequent cohorts of residents.

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[217] 79 T.C. 313, 322 (1982), *acq.*, *action on decision* 1984-051 (July 16, 1984).

[218] Typically, bond holders require an actuarial feasibility study for not-for-profit CCRCs, and banks require a Big-5 accounting firm feasibility study for for-profit CCRCs. Interview with Kathleen Harris, A.V. Powell & Associates, Inc., in Chesterfield, Missouri (Jan. 21, 1998).

V. Conclusion

CCRC residents may deduct the portion of their entrance and monthly fees attributable to medical costs on their tax returns in the year paid per IRS rulings and court holdings.[219] Typical residents may deduct $20,000 or more in the year they pay their entrance fee and $3,000 or more annually for their monthly fees. To do so, residents must obtain a statement from the CCRC advising them of the portions of their fee payments that are for medical care. Most residents (those deemed chronically ill) in assisted living units (ALUs) and all nursing care residents should be able to deduct 100% of their monthly fees. Depending on the calculation method used, however, the entrance fee medical expense deduction may be reduced by a CCRC's promise to refund part or all of the fee when the resident moves out or dies.

Because residents bear the burden of proving that the deduction is valid, it behooves them to determine whether the CCRC has calculated the medical expense allocation of their fees properly. We have found that the typical CCRC is not careful in its computations or is overly conservative in its advice to its residents. One warning signal is if the CCRC assigns the same medical deduction percentage to both the monthly fees and the entrance fee. There is little basis for this because the entrance fee provides long-term capital for the CCRC and is related to the guarantee of future medical care in an ALU or nursing care unit, whereas the monthly fees are related to the day-to-day medical costs such as front desk monitoring of emergency pull cords, transportation to the doctor, special dietary considerations, and having a nurse on duty. We advise

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[219] Although the IRS has recently exhibited some discomfort with allowing a full deduction in the year paid for the medical portion of an entrance fee because the fee relates to future medical care, it still allows it. *See* discussion *supra* section II.B.3.a.

residents or their tax advisors to ask their CCRC for supporting documents to verify the size of the deduction and the reasonableness of the computational method. If not satisfied, they should do their own calculations since they, not the CCRC, must defend the deduction to the IRS.

Specifically, we suggest the steps that CCRCs should follow in computing the medical cost portion of their residents' entrance fees and we recommend that the CCRCs use data from an actuarially-based feasibility study. Most CCRCs or their parent organizations have likely had such a study done during the planning stage of the facility. The expected future medical costs of the CCRC are estimated actuarially and are undoubtedly figured into the fees. To estimate the medical portion of monthly fees, we suggest analyzing each direct cost category[220] in the CCRC's annual operating statement to determine the percentage attributable to medical care. The weighted average percentage across all the categories should then be multiplied by the total monthly fees paid by ILU residents for the year, and the result should be divided equally among them. Care should be taken not to include ALU or nursing care expenses in the calculation.

The deductible amount of either type of fee should be the same per capita amount for each resident rather than a percentage of the fees paid unless the differences in fees are due to different levels of medical care rather than different residential unit sizes. Unit size is unrelated to the expected medical costs per resident.

Entrance fee refunds pose a potentially serious tax problem for CCRC residents and the CCRCs themselves. In particular, because the refunds are usually non-interest-

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[220] Direct costs are those that directly benefit the residents such as food service, front desk and security, utilities, medical services, laundry and housekeeping, and social activities. Indirect or support costs include, among other things, administration, accounting, finance and interest, depreciation, and marketing. These support costs effectively take on the weighted-average medical cost percentage determined from the direct cost categories.

bearing, they may be classified as below-market-rate loans under section 7872. Based on our analysis of the law and judicial opinions, we conclude that few refunds will be so classified. First, section 7872(g) exempts refunds below an inflation-adjusted amount, currently $134,800,[221] for residents at least 65 years old. Second, we determine that refunds over that amount are term loans rather than demand loans and as such are discountable over the actuarial life of the resident. Their discounted value in many cases will be less than half the face value. Therefore, most entrance fee refunds of less than $250,000 will be exempt from the section 7872 rules.

For larger refunds that are not entirely exempt, only the portion of the discounted value in excess of the exemption amount will be subject to the imputed interest rules. In that case, the residents will have to report imputed interest income, and the CCRCs, imputed interest expense, on their tax returns. Examples of these computations are provided in section III.B.4., *supra*.

Entrance fee refunds also have tax implications regarding the medical expense deduction. The IRS has ruled that if a medical expense deduction has been taken on the full entrance fee, a subsequent refund would trigger recapture of the previously deducted medical expense associated with the refund. The recaptured amount is taxable income mitigated by the tax benefit rule. Only CCRC residents who move out prior to death will be affected, whereas estates and beneficiaries of decedent residents get a tax break. Because CCRC contracts are normally written such that the estate or other beneficiary will receive the refund, the previously deducted medical expense associated with the

[221] Rev. Rul. 97-57, 1997-52 I.R.B. 16.

refund is not income with respect of the decedent under section 691 since the right to receive it did not arise until death.

If the CCRC advises a resident that a percentage of the entrance fee is for medical care, we are apprehensive that there is a risk in taking the medical expense deduction on the full entrance fee if part of the fee is guaranteed refundable. Because the refund is treated as a loan, and loans are not tax deductible, the medical expense attributable to the refundable portion may not be deductible. Neither the IRS nor the courts have addressed the treatment of guaranteed refunds as yet. Although we would not discourage a resident from taking this more aggressive position, we recommend taking the deduction on the net entrance fee — the fee less the discounted present value of the guaranteed refundable portion. We believe a better approach for CCRCs, though, is to advise their residents that a lump sum rather than a percentage of the entrance fee is for medical care. The CCRC then may assert on behalf of the residents that the per capita, lump-sum medical expense portion is fully deductible because it will be paid out of the non-refundable part of the entrance fee.

There is gold at the end of the rainbow for CCRC residents. The tax savings from deducting the medical expense portion of CCRC fees may be great, as in the case of Mrs. W who received a tax refund of more than $5,000 on the entrance fee alone. To uncover the full pot of gold, though, residents have a duty to better inform themselves about the issues, and CCRCs have a fiduciary responsibility to help their residents get the greatest and most accurate deduction possible.