Deducting Continuing Care Retirement Community Fees as Deductible Medical Expenses

This Tax Action Memo was written by Tax Action Panel member William R. Bischoff, CPA of Colorado Springs, Colorado.

Background

Your clients may have parents or loved ones who are considering entering a Continuing Care Retirement Community (CCRC). This can involve a significant financial commitment. The good news is it can also create unexpected tax benefits, in the form of medical expense write-offs that can lower the cost. Before addressing the tax angle, let's first cover how CCRCs work.

CCRC Basics

In contrast to an assisted care facility (basically a garden-variety nursing home), a CCRC enters into a lifetime contract with the resident. The resident pays a one-time entry fee and ongoing monthly fees in exchange for a residence and the provision of onsite medical and personal care services. The lowest level of care is independent living, which involves no nursing care. As the resident's needs increase, the levels of healthcare and personal services can be increased to include assisted living services, long-term care, and skilled nursing services if necessary. As you can see, the big advantage of the CCRC concept is that the resident doesn't need to move as his or her needs change. Other names for CCRC-like arrangements are "Life Care," "Life Care Facilities," and "Life Care Communities."

Most CCRCs also provide onsite preventive care such as immunizations, physical exams, nutrition counseling, exercise programs, and physical therapy. Physicians, diagnostic testing, and various other healthcare and personal care services may also be offered in an onsite outpatient clinic, skilled care facility, or in the resident's home. Other amenities, such as meal plans; housekeeping; transportation; and social, educational, and recreational activities, can be tailored to suit each resident's needs and preferences.

A CCRC can range from patio homes, duplexes, or townhouses to high-rise apartments. Residences can be quite upscale or even lavish. Depending on the community and the arrangement the resident signs up for, he or she may be strictly a renter or have an ownership stake in the real estate.
Fees and Contractual Arrangements

The CCRC resident must usually pay a one-time entry fee plus monthly maintenance fees thereafter. In areas where real estate is expensive and the resident acquires an ownership stake, the entry fee can be in the high six figures and up. Monthly fees can be $5,000 and up in high-cost areas. The resident's health status on Day One is often the biggest factor in setting the initial monthly fee level. Another big factor is whether the resident is single or married (at this stage of life, two cannot live as cheaply as one).

With a CCRC, there are usually three types of contracts and fee arrangements to consider. They all include housing, some degree of residential services (such as yard maintenance and interior cleaning), and short-term and emergency medical care. The differences are in the additional services and, of course, the cost.

1. Extensive Contracts. These deals offer unlimited long-term nursing care with little or no significant increase in the usual monthly fee level. Because this option makes a high level of service available on Day One, it's the most expensive type of contract. However, it could prove to be the most cost-effective if lots of skilled nursing care is provided for a long time.

2. Modified Contracts. These deals provide a specified amount of health care or long-term nursing care. If the level of care is stepped up, additional fees are charged at that point.

3. Fee-for-Service Contracts. These arrangements simply require residents to "pay as they go" for medical services and long-term care at prevailing rates. The advantages here are a lower price if the resident stays healthy and the availability of onsite medical and personal care services should the need arise.

Now, it would be nice if CCRC residents could offset some of their costs by claiming itemized deductions under IRC Sec. 213 (subject to the 7.5%-of-AGI deduction floor) for medical expenses that are implicitly included in their fees. Thankfully, this is often possible according to IRS guidance and an instructive Tax Court decision. Here's the story.

Case Study on How Medical Expense Deductions Can Lower CCRC Costs

In 1989, Delbert Baker [122 TC 143 (2/19/04)] and his wife bought into a gated, guarded, resort-style CCRC in California. It provided four living arrangement categories with increasing levels of included medical services: (1) independent living, (2) assisted living, (3) special care (for victims of Alzheimer's and Dementia), and (4) skilled nursing. The Bakers paid an entry fee of about $130,000 plus monthly fees of about $2,200 for the years in question in exchange for lifetime residential privileges in the community. (Both the entry fee and the monthly fees would be much higher these days.)

The couple started off in the independent living category and occupied a two-bedroom, two-bath duplex unit. The unit included a monitored emergency pull-cord system for medical crises. The Bakers also had access to most medical services available at the CCRC's onsite health center. Other amenities available to the independent living status residents like the Bakers included a pool, spa, and exercise facility.
On their Form 1040 for the year they entered the CCRC (1989), the couple claimed $34,541 of the entry fee as a medical expense. This return apparently wasn't audited. Later, the Bakers claimed medical expense deductions of their 1997 and 1998 monthly fees equal to 40.3% and 41.6%, respectively. Those years were audited. The percentages were calculated by an ad hoc committee of CCRC residents using certified financial information provided by the VP of finance for the nonprofit entity that operated the CCRC. (Mr. Baker was a member of the committee.) Essentially the percentages are obtained by dividing total annual medical expenses incurred by the CCRC by total annual fees collected from the residents. The Bakers claimed additional medical expense deductions based on Mr. Baker's use of the pool, spa, and exercise facility. His doctor stated in writing that swimming, whirlpools, and exercise were imperative to maintaining Mr. Baker's health since he suffered from hypertension, heart disease, and arthritis.

Upon audit, the IRS disallowed a portion of the Baker's medical expense deductions by using a percentage of 19.01% of the monthly CCRC fees instead of the Baker's much higher percentages. All the deductions for use of the pool, spa, and exercise facility were completely disallowed. When the case went to court, the IRS changed its position and claimed that any allowable medical expense deductions must be based on complicated actuarial calculations involving assumptions as to longevity and healthcare utilization.

**Percentage Method Is Okay.** The Tax Court's first order of business was to decide if the relatively straightforward percentage method could be used to determine the CRCC fees allocable to medical expenses or if the IRS could require taxpayers to use the much-more-complicated actuarial method. Round One went to the taxpayers. The Tax Court noted the IRS had repeatedly allowed the percentage method and had never issued any guidance that would disallow that method. (See Rev. Ruls. 67-185, 75-302, and 76-481.) (This is still true today.) So, the percentage method is allowed, and taxpayers are not required to hire actuaries whenever they enter CCRCs. Good!

In Rev. Rul. 76-481, the IRS stated that to the extent the CCRC can reasonably estimate the percentage of overall operating expenses spent to provide medical care, residents can use that percentage to calculate medical expense deductions based on: (1) the one-time entrance fee and (2) monthly fees. This is the case even though the actual medical services may not be provided until years later.

**Example 1: CCRC fees allocable to medical expenses using IRS approved percentage method.**

Phil and Jill, both age 68, make arrangements to enter Cadillac Care Retirement Community (CCRC). CCRC promises to provide the married couple with accommodations, one meal per day, activities, and lifetime care, which includes certain medical care. In return, Phil and Jill pay a $300,000 one-time entry fee and monthly fees of $4,000 subject to annual adjustments for inflation. CCRC provides Phil and Jill with believable documentation indicating that 30% of its operating expenses are incurred in providing medical care for the residents ($4.5 million for medical care out of total expenses of $15 million). Using this information and the IRS-approved approach to the percentage method, Phil and Jill can count 30% of their $300,000 entry fee (or $90,000) as a medical expense in Year 1. They can also count 30% of their monthly fees (or $1,200 per month based on current charges) as medical expenses.
Warning: Under Rev. Rul. 93-72, the taxpayer must enter into a contractual lifetime care arrangement (as was the case in *Baker*) to claim current deductions for what amounts to prepaid medical care.

So far, so good. Next, the Tax Court disagreed with the IRS-approved percentage method, which is based on the fees paid by each taxpayer (as illustrated in Example 1). The Tax Court felt this method gives an unfair advantage to single residents and those who sign up for larger or more luxurious units, as it allows these folks to claim higher deductions simply because they pay higher fees. To eliminate this perceived shortcoming, the Tax Court says the percentage method calculation should be made on a per person basis.

**Example 2: Fees allocable to medical expenses using Tax Court approved percentage method.**

Same as Example 1, except this time Phil and Jill use the Tax Court's version of the percentage method. CCRC collects an average entrance fee of $100,000 per person for the year in question (based on total entrance fees divided by the number of new residents entering that year) and an average monthly fee of $2,500 per person (based on total monthly fees divided by total resident months for that year). Using the Tax Court's method, Phil and Jill can treat $60,000 of their entrance fee as a medical expense ($100,000 per person x 2 x .30). They can also treat $1,500 of each monthly payment as a medical expense ($2,500 per person x 2 x .30). Under the particular facts in these examples, you can see that using the IRS-approved method will result in a bigger medical expense deduction from the entrance fee but a smaller deduction from the monthly fees. However, the outcome could be the other way around if the facts were different.

**Note:** If another taxpayer pays over 50% of the support for the CCRC resident (such as their adult child), and that other taxpayer pays the CCRC costs, he or she can report the same amounts as Schedule A medical expenses. This is true even if the other taxpayer cannot claim the CCRC resident as a dependent because their gross income is too high. [See IRC Sec. 213(a).]

**No Deductions for Pool, Spa, or Exercise Facility.** Not surprisingly, the Tax Court agreed with the IRS that the Bakers couldn't claim any medical expense deductions for Mr. Baker's use of the CCRC's pool, spa, and exercise facility. However, this was mainly because the taxpayer failed to present a supportable allocation of entrance and monthly fees to the operation and maintenance of these amenities. The Tax Court noted, however, that expenses allocable to the pool, spa, and exercise facility wouldn't be deductible as medical costs if using those amenities is simply beneficial to the taxpayer's overall health (as opposed to something that is necessary to prevent or alleviate one or more specific medical conditions).

**No Deductions for Purported Entry Fees That Are Actually Loans**

In *Finzer* [100 AFTR 2d 2007-5340 (DC N. Ill. 2007)], the taxpayer paid what appeared to be an entry fee of about $724,000 to a CCRC. Upon closer inspection, however, the contract between the resident (i.e., the taxpayer) and the CCRC clearly provided that at least 90% of the entry fee was actually an interest-free loan from the resident to the CCRC. If the contract was terminated for any reason (including the resident's
death), the resident (or the resident's estate) was entitled to a refund of the entire entry fee minus 2% for each month of residence before the termination. However, the minimum refund was set at 90% of the entry fee amount. The contract documents included a promissory note that treated the entire entry fee amount as a loan. Accordingly, the U.S District Court of Northern Illinois denied the taxpayer's attempt to claim additional medical expense deductions allocable to the purported entry fee.

What about Refunds of Honest-to-Gosh Entry Fees?

According to Rev. Rul. 75-302 and 76-481, the fact that a portion of a resident's entry fee amount might be refunded under certain circumstances does not prevent the resident from treating an allocable percentage of the entry fee as a medical expense—as explained earlier in this article. If a refund occurs, the amount of the refund that was previously treated as a deductible medical expense must be reported as gross income in the year the refund is received. The 2007 Finzer decision distinguishes the refunded entry fee scenario from the situation where a purported entry fee is actually a loan from the resident to the CCRC. According to Finzer, a loaned amount cannot be treated as a medical expense, which only makes sense.

Conclusions

The Tax Court's Baker decision is favorable because it confirms the notion that taxpayers who enter CCRCs can often qualify for substantial medical expense deductions even when they are currently in good health and despite the 7.5%-of-AGI floor. This is particularly true in the first year if a hefty entrance fee is paid. And no actuaries are required. We like that! The curve ball in the Baker decision is the Tax Court's preference for using a per person concept in applying the percentage method to calculate retirement community fees allocable to medical expenses. However, this is actually good news too because taxpayers can now follow the IRS-approved version of the percentage method (per Rev. Rul. 76-481, as illustrated in Example 1) or the Tax Court's version (as illustrated in Example 2), whichever version suits them best. Both versions currently have substantial authority for IRS penalty-avoidance purposes [Reg. 1.6662-4(d)].

Finally, the Finzer [1 00 AFTR 2d 2007-5340 (DC N. Ill. 2007)] decision stands for the common sense proposition that an amount loaned by a resident to a CCRC cannot be treated as medical expenses.

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