

SPECIAL ISSUE

brief



MEDICAL EXPENSE TAX DEDUCTIONS: A GUIDE FOR SENIOR LIVING PROVIDERS AND RESIDENTS

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Seniors
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MEDICAL EXPENSE TAX DEDUCTIONS: A GUIDE FOR SENIOR LIVING PROVIDERS AND RESIDENTS

I. The Moving Target Of Deductibility

In recent years, the deductibility of resident payments for senior living services as medical expenses has come under increased scrutiny. The very definition of “medical” expense is malleable, and the middle ground, inhabited by most senior living communities, that lies between traditional, deductible, “institutional” health care and non-deductible residential services and accommodations, is sometimes difficult to categorize. The increasing complexity of resident fee structures and refund arrangements casts further doubt on when a payment should be characterized as an expense, and what fees are attributable to medical care.

The growth of the senior living industry, along with the government’s constant need for more sources of revenue, has resulted in expanded IRS and court activity related to residents’ claims that some or all of their retirement community fees are deductible as medical expenses. Moreover, residents themselves have become more aggressive in seeking tax deductions after seeing their investments dwindle as a result of the recession. In an effort to maximize their deductions, they are questioning data given to them by senior living providers.

Seniors housing and care operators can use the tax deductibility of some or all resident fees as a marketing incentive in these times when it is more challenging to fill a vacancy. Managers often want to give residents data they can use in their tax reporting, but must be careful not to misrepresent the availability of medical expense tax deductions, and certainly do not want to give tax advice to their residents.

This Guide is designed to be used by anyone who is interested in the subject, including senior living operators, residents and their tax advisors, but ultimately the taxpayer is responsible for any deductions claimed.

II. The Medical Expense Deduction In General

A. Amount Deductible

The Internal Revenue Code permits a deduction from an individual's income tax for expenses paid during the taxable year, not compensated by insurance or otherwise, for medical care of the taxpayer, the taxpayer's spouse or a dependent, to the extent that such expenses exceed 7.5% of adjusted gross income.¹ After December 31, 2012, the 7.5% threshold will be increased to 10% except that, through 2016, it will remain at 7.5% if the taxpayer or spouse has reached 65 years of age before the close of the tax year.² After December 31, 2016, all taxpayers will be subject to the 10% adjusted gross income threshold, with no exception based on age.³

B. Definition of Medical Care

Medical care is defined as "amounts paid for the diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure of the body."⁴ Medical care also includes "qualified long-term care services."⁵ Hospital and nursing services are included.⁶ The remainder of this Guide concerns health-related services and senior living communities that are outside the institutional hospital setting.

III. Eligibility of Assisted Living and Skilled Nursing Services

A. When Room and Board Is Deductible in a Non-Hospital Setting

IRS regulations state that the extent to which care at a place other than a hospital constitutes deductible medical care is primarily a question of fact, which depends upon the condition of the individual and the nature of the services received.⁷ The regulations specify that where the "availability of medical care... is a principal reason" for the taxpayer's presence there, and meals and lodging are furnished as a necessary incident to the care, the entire cost of medical care and meals and lodging at the "institution" is a deductible medical expense.⁸ On the other hand, if "an individual is in a home

¹ I.R.C. §213(a)

² I.R.C. §213(f)

³ I.R.C. §213(f)

⁴ I.R.C. §213(d)(1)(A)

⁵ I.R.C. §213(d)(1)(C); see section III.C. below.

⁶ 26 CFR § 213(e)(1)(ii)

⁷ 26 CFR § 213(e)(1)(v)

⁸ 26 CFR § 213(e)(1)(v)(a)

for the aged for personal or family considerations and not because he requires medical or nursing attention,” meals and lodging at the home are not considered a cost of medical care and only that part of the cost of care attributable to medical care or nursing attention will qualify.⁹

These regulations leave open the question of whether care from unlicensed personnel, rather than physicians and nurses, qualifies for the deduction.

B. Personal Care as Medical Care

There are few tax authorities that categorically state that personal care or assisted living, whether in an “institution” or a private home, qualifies as “medical care.” Because such services are often performed by unlicensed individuals, the determination normally is based on the particular facts and circumstances at hand.

In one case, the U.S. Tax Court determined that payments to an in-home attendant, who assisted an elderly woman with severe arthritis, were for the provision of medical care, even though the attendant was not a licensed nurse and had no special training.¹⁰ In another Tax Court case, in-home personal services delivered to one spouse by untrained attendants, such as bathing, grooming, medication management, cooking and light housekeeping, were determined to be only 75% deductible as medical expenses, because some of the cooking and housekeeping services incidentally benefited the other spouse.

In the context of a retirement community, fees for nursing care and personal care, such as assistance with bathing, dressing and grooming, have been determined to be deductible as medical expenses, whereas fees paid for mere household assistance (*e.g.*, assistance with shopping) are not deductible.¹¹ Also, in *Baker v. Commissioner*,¹² the Tax Court agreed with both the taxpayer and the IRS’s expert that expenses allocated to an assisted living facility, special care (dementia) unit, and a skilled nursing facility should be included as medical expenses.

As a practical matter, when personal care services are rendered in a licensed setting, such as an assisted living facility or skilled nursing facility, and the primary purpose of the resident’s presence there is to receive such services, the entire fee for the service should be deductible as a medical expense, without any allocation for nondeductible room and board charges.

⁹ 26 CFR § 213(e)(1)(v)(b)

¹⁰ Est. of Dodge, T. C. Memo 1961-346; note, however, that services provided by unlicensed caregivers were not considered medical in nature, but were deductible as “qualified long-term care services” under §7702. Est. of Baral, 137 T. C. 1 (2011)

¹¹ Rev. Rul. 76-106

¹² 122 T. C. 143 (2004)

If the availability of medical care is not a principal reason for the person's presence, the cost of room and board should be subtracted, and only that part of the cost attributable to medical care should be deductible. One common situation that probably would not result in full eligibility for a medical expense deduction, is where a resident who does not need care moves into the assisted living facility for the primary purpose of residing with a spouse who does need care.

C. Qualified Long-Term Care

In 1996, the Internal Revenue Code¹³ was amended by the Health Insurance Portability and Accountability Act (HIPAA) to specify that deductible medical expenses include “qualified long-term care services.” Such services include, among other things, maintenance or personal care services that are required by a “chronically ill individual” pursuant to a plan of care prescribed by a licensed health care practitioner (including physicians, nurses and social workers). A “chronically ill individual” is one whom the health care practitioner has certified as being unable to perform at least two activities of daily living for a period of at least 90 days due to a loss of functional capacity or who requires substantial supervision resulting from threats to health and safety due to severe cognitive impairment.

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

IV. Independent Living Resident Fees In Lifetime Care Facilities

In general, residents in independent living accommodations are not there primarily to receive medical care. However, residents of a continuing care retirement community (“CCRC”) often make payments in a given tax year in order to receive care in future years. The rulings examining the tax deductibility of such payments focus upon the kinds of fees being paid, the timing and use of such payments, how the CCRC accounts for its medical costs, how medical costs are allocated among residents, and to what extent fees are refundable, among other considerations.

¹³ IRC § 213(d)

A. Fees Eligible for Deduction

1. Expenditures for Future Care

Portions of entrance fees and monthly fees paid by independent living residents of a CCRC or other “lifetime care facility”¹⁴ are deductible to the extent that they represent a charge or prepayment for future assisted living or skilled nursing care. Numerous IRS rulings establish the deductibility of such charges.

A percentage of the monthly fee charged to residents in independent living by a life care facility was deductible on the basis that it represented the cost of medical care.¹⁵ Portions of both entrance fees and monthly fees charged by a retirement community that offered 10 free days of care and charged 90% of market rates for remaining days of care, were deductible as medical expenses.¹⁶ A percentage of an entrance fee allocable to medical care was found to be deductible, provided that any refunded portions are to be reported as income.¹⁷ And an entrance fee paid for lifetime lodging in a full-service retirement community was deemed to be deductible only to the extent of the approximately 7% of the entrance fee that was estimated, based on historical experience, to be the cost of providing a limited number of days of prepaid care in the adjacent nursing facility.¹⁸

2. Deductible and Nondeductible Costs

Fees paid for nursing care and personal care, including assistance with bathing, dressing and grooming, are deductible, whereas fees paid for mere household assistance, such as assistance with shopping, are not.¹⁹ The following components of a retirement community’s medical expenses are deductible: staff costs; medications and supplies; pro rata shares of housekeeping, maintenance, utilities, administrative and marketing costs; interest on indebtedness; real estate taxes; insurance; and depreciation of the building.²⁰ Portions of fees used for the construction of health care facilities are not deductible.²¹

¹⁴ Rev. Rul. 93-72; lifetime care facilities are not defined, but likely would exclude month-to-month, annual or other fixed-term contracts, and would include contracts where the resident’s occupancy can be terminated only for cause.

¹⁵ Rev. Rul. 67-185

¹⁶ Priv. Ltr. Ruls. 8930023 and 8930024

¹⁷ Rev. Rul. 75-302.

¹⁸ Est. of Smith, 79 T. C. 313 (1982)

¹⁹ Rev. Rul. 76-106

²⁰ Priv. Ltr. Rul. 8630005

²¹ Rev. Rul. 76-481

3. Refundable Entrance Fees

An entrance fee arrangement that includes a refund privilege may qualify for a medical expense deduction, depending upon the nature of the refund terms.

Two IRS rulings permitted medical expense deductions for entrance fees that were conditionally refundable. A percentage of an entrance fee allocable to medical care was found to be deductible, even though it was conditionally refundable, provided that any refunded portions were reported as income.²² Similarly, a portion of a life care “founder’s fee” was considered deductible even though the fee was subject to a refund computed in accordance with a specified formula that included a penalty provision.²³ These rulings were issued at a time when CCRC contracts typically provided for amortization of the refund to zero within the first 50 to 100 months of occupancy.

However, in *Finzer v. United States*,²⁴ the court agreed with the IRS that an entrance fee that is 90% refundable upon contract termination, regardless of the length of occupancy, is, to that extent, a loan from the taxpayer, and not an expense, and therefore cannot qualify for the medical expense deduction. The court noted that the CCRC “places no conditions on the resident’s entitlement to a refund, other than that [the CCRC] has one hundred twenty days after termination to give a former resident (or his estate) the money.” The 10% that is nonrefundable, or becomes nonrefundable over time, should be eligible for treatment as a medical expense.

4. Ancillary Services

Certain ancillary health-related services available in the independent living portion of a CCRC have been found to qualify for a medical expense deduction, but the approval or disapproval of such expenses was based largely upon the parties’ ability to meet shifting burdens of proof in a Tax Court case.²⁵ Allowed expenses included the cost of maintaining a monitored emergency pull cord system. Disallowed expenses included costs allocable to the pool, spa and exercise facilities.

B. Calculating the Provider’s Medical Care Cost

When determining the amount of CCRC entrance fees or monthly fees that are eligible for a medical deduction, the rulings look to the provider’s costs of operations and determine the amount allocable

²² Rev. Rul. 75-302.

²³ Rev. Rul. 76 – 481.

²⁴ 496 F. Supp. 2d 954 (N.D. Illinois, 2007)

²⁵ Baker v. Commissioner, 122 T. C. 143 (2004).

to medical care. The rulings may also look to how the paid-in fees are used by the provider. To address the confusion raised by some of these rulings, CCRC providers may want to consider furnishing residents with itemized invoices delineating which charges are for medical services and which are for other services and amenities.

I. Departmental Cost / Percentage Approach

In Rev. Rul. 75-302, 30% of a lump-sum entrance fee was found to be deductible where the life care retirement community, based on its prior experience, showed that the cost of furnishing medical care, medicine, and hospitalization averaged about 30% of its total life care budget and gave the taxpayer a separate statement to that effect. Similarly, in Rev. Rul. 76-481, 10% of the life care founder's fee and 15% of monthly fees for a new community were deemed to be deductible as medical expenses, based on data from a comparable retirement community.

In *Baker v. Commissioner*,²⁶ a medical deduction was allowed for 41 percent of monthly fees paid to a CCRC. The court approved the following departmental cost method for determining a percentage of fees deductible as medical expenses: divide the operating costs of the skilled nursing facility, assisted living facility and special care (dementia) units by the total cost of operating the community. The calculation included interest, depreciation and amortization in both the numerator and denominator, but revenues and expenses related to non-CCRC-contract residents were excluded.

These rulings support deduction as medical expenses of a fixed percentage of all fees paid to a CCRC. Under this method, if the resident chooses to take a medical expense deduction for a portion of fees paid while in independent living, he or she should not also deduct 100% of the monthly or daily fees paid while in assisted living or nursing. On the other hand, by spreading medical expenses over all the fees paid to the CCRC throughout a period of years, it may be more difficult for the resident to exceed the annual 7.5% of adjusted gross income threshold needed for the expenses to be deductible.

2. Per Capita Versus Percentage-of-Fee Allocation

In Revenue Rulings 75-302 and 76-481, a percentage-based medical deduction was applied to the total CCRC entrance fee or monthly fees paid by the taxpayer. However, more recently, the IRS and courts have questioned whether a percentage-of-fee approach properly reflects the amount deductible as a medical expense.

²⁶ 122 T. C. 143 (2004)

In *Finzer v. United States*,²⁷ the court noted that entrance fees in one CCRC ranged from \$275,000 to over \$700,000, even though all residents received “the same access to assisted living and nursing care regardless of the size of their residential unit or the entrance fee they pay.” While the court approved of the percentage method of determining medical expenses at a CCRC, it stated that the applicable percentage should be applied to the lowest entrance fee at the community, that this number should be the maximum medical deduction taken by any resident regardless of the size of his or her entrance fee, and that any amount above that “relates solely to the quality of the housing unit selected and has no relation to the [taxpayer’s] medical costs.”

Similarly, in *Baker v. Commissioner*,²⁸ the Tax Court applied the 41% medical expense allocation to the weighted average of monthly fees, rather than the actual fee paid by the taxpayer, stating that it “fail[s] to see the relationship between the health care expenses of residents and the size and cost of their ILUs [independent living units].”

Typically, the deductibility of a medical expense is measured by the charge paid by the taxpayer, rather than by the cost to the health care provider. It can be argued that a CCRC’s per capita cost of medical services is irrelevant, and that if charges paid by residents vary widely for the same level of access to care, the full charges should be deductible as a medical expense. However, in the aftermath of *Finzer* and *Baker*, advancing such a position is likely to be an uphill battle. The idea that fees are not deductible to the extent that they vary based on the value of an independent living apartment, also appears to be consistent with the rule that costs of construction of a medical facility cannot be counted in the determination of a medical deduction.²⁹

Recently, some CCRC residents have been denied medical expense deductions that were based on the application of a flat percentage to the actual entrance fee they paid, with the IRS agent stating that the percentage should be applied to the lowest entrance fee or the average entrance fee for the community. IRS agents have also contacted CCRCs directly, inquiring how the organization arrived at the percentage of overall costs representing medical care. We are likely to see more challenges of this type in the future.

3. Subsidy / Actuarial Method

An alternate approach for allocating deductible medical expenses is the “subsidy” method. In some CCRCs, this method may allow the resident to deduct 100% of fees paid while in assisted

²⁷ 496 F. Supp. 2d 954 (N.D. Illinois 2007)

²⁸ 122 T. C. 143 (2004)

²⁹ Rev. Rul. 76 – 481

living and nursing, plus an amount that represents the extent to which entrance fees [and possibly independent living monthly fees] subsidize the cost of operating those care facilities.

In a typical “Type A” or life care CCRC, there is no substantial increase in monthly fees when a resident moves from independent living to assisted living or skilled nursing. Assisted living and skilled nursing operating costs are subsidized by revenues from entrance fees, independent living monthly fees, or both. A similar approach also may be used by “Type B” CCRCs, where a limited number of prepaid care days, or a discounted rate for care, is offered.

To the extent entrance fees or independent living monthly fees are used to subsidize assisted living and skilled nursing operations, they should be deductible as prepaid medical expenses. One way to calculate the prepaid medical expense is to divide the dollar amount of the annual subsidy needed to run the assisted living and skilled nursing departments by the number of independent living residents and multiply that number by the average life expectancy of independent living residents.

In the *Baker* case, the Court rejected the IRS’s position that medical deductions must be based upon an actuarial estimation of residents’ health facility utilization levels, but it is still a valid method of estimating the cost of medical care being purchased by a resident.

As suggested by the *Finzer* and *Baker* cases, any actuarial cost of care or subsidy amount should be applied to entrance fees and/or monthly fees in a way that yields a per capita result that is the same for each resident, rather than an amount that varies based on the size of the fee actually paid by each resident.

4. Reconciling the Percentage and Subsidy/Actuarial Methodologies.

The percentage of cost methodology is arguably less desirable for the resident than the subsidy/actuarial methodology, depending on the particular taxpayer’s situation.

Under the subsidy/actuarial model, a resident may take a significant deduction by attributing the entire prepaid medical expense (subsidy amount) to the entrance fee, thus needing to exceed the 7.5% threshold only once during his or her independent living years. Applying the departmental cost / percentage method to independent living monthly fees, as in the *Baker* case, a resident would need to exceed the 7.5% threshold each year before being able to recognize any deductible medical expense.

If the percentage derived from a departmental cost analysis (e.g., 30%) is applied to all fees, including the entrance fee, a resident in assisted living or nursing would be limited to deducting the same percentage while he or she was in independent living. To take any higher amount would seem to constitute excessive recognition of medical expenses or “double-dipping.”

Depending upon the individual’s financial and tax circumstances, it may be more desirable for the resident to take higher tax deductions while in assisted living or nursing, particularly if his or her monthly expenses have increased as a result of a transfer to the care facility. In such a case, it may be better for the resident to apply 100% of the medical expense figure determined by the subsidy method to the entrance fee, and deduct 100% of any out-of-pocket fees paid while in assisted living or nursing.


5. What Fees Are Allocable to Care?

Because residents pay both entrance fees and monthly fees in years when they receive no actual care, there is a question regarding which fees are allocable to medical care and which fees should be allocated to other services, amenities or accommodations.

Both the *Finzer* and *Baker* cases focus on the CCRC’s costs, rather than the amounts being charged to and paid by the resident. In the *Finzer* case, the court reviewed evidence regarding how the CCRC actually used entrance fees and monthly fees, finding that all medical expenses were paid for with monthly fees, and that none of the entrance fee proceeds were used to provide services to the residents. In the *Baker* case, however, the court concluded that neither the entrance fees nor monthly service fees were allocated to any specific costs, and therefore it was assumed that fees were applied equally to all expenses.

C. Role of CCRC Providers

Ultimately, all the CCRC can and should do with cost information is to report the relevant data to residents and allow them to claim medical deductions as they see fit, in consultation with their personal tax advisors. It may be useful for CCRCs to report both the subsidy amount, if any, that is not covered by periodic fees paid by residents in the care facilities, as well as the percentage of overall costs represented by the operations of those facilities. In light of the *Finzer* and *Baker* cases, CCRCs may wish to provide residents not only with the percentage of medical expenses applicable to their own entrance and monthly fees, but also with the average and/or lowest entrance fees and monthly fees being charged within the community. An alternative is to give each resident a specific per capita medical care cost for each tax year.



The disconnection between the IRS revenue rulings and the *Finzer* and *Baker* cases may cause CCRC providers to rethink how they charge for medical care services. For example, if medical care were specifically itemized on entrance fee and/or monthly fee billings, residents would know exactly what they were being charged and the IRS and courts might be less inclined to inquire into the cost structure of the CCRC's operations or to trace fee revenues and match them to different types of expenditures.

After receiving the CCRC's data, residents and their tax advisors can turn to outside resources, such as trade association publications, to gain a better understanding of how to apply the CCRC's information in a way that best suits their individual tax circumstances. Under no circumstance should CCRC management give tax advice to residents and any letter furnishing medical expense information to residents should expressly disclaim that any advice is given about how to use it.



V. Conclusion

In the future, the kinds of non-institutional services that qualify as medical care that is eligible for a tax deduction are bound to evolve as surely as will the service offerings of senior living providers. At some point, as more IRS and court rulings in this area are developed, a line is likely to be drawn that more clearly marks the limit of what services and amenities may be included within the definition of deductible medical expenses.

For CCRCs with widely varying entrance fees that are not directly correlated to differences in health benefits, application of a uniform medical deduction percentage likely will continue to be subjected to increasing scrutiny. CCRC providers will need to seriously consider what operating cost data are given to residents, whether to disclose the ranges of fees being paid by other residents, whether to develop a single medical expense cost for each resident, and whether to itemize medical expense charges when collecting fees from independent living residents.





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