Are long-term care operators facing new IRS challenges?

IRS reverses course and withdraws more than $128 million assessment in entrance fee dispute.

By Brian A. Cromer

In a positive development for the long term care community, the IRS has changed its position in an important tax case involving the taxability of entrance fees paid by residents of continuing care retirement communities (“CCRCs”), and withdrawn its assertion that the CCRC operator owed more than $128 million in taxes and penalties associated with those fees. However, despite changing course in this case, the IRS continues to maintain that entrance fees may constitute taxable income in other instances without providing much additional guidance.

In general, CCRC’s are communities that seek to provide lifetime care for older adults, with multiple levels of care being offered based on the needs of the residents. For example, the levels of care in a particular CCRC may include independent living, assisted living and skilled nursing, usually in a campus setting. Residents do not own their units but enjoy the right to stay in the same general location as their levels of acuity increase.

Although there are broad variations in the particular types of contracts that are offered to CCRC residents, a common feature of the business model in the case of contracts for the most expansive range of service and care is the use of entrance fees. In a typical scenario, a prospective resident with equity in his or her home may sell the house and use net proceeds to help fund the payment of an entrance fee to the CCRC. Entrance fees may range from the traditional non-refundable version to fees that are refundable based on a variety of contingencies, such as voluntary withdrawal, death of the resident or the re-occupancy of the unit. Many of the CCRC’s using this method today employ a formula that provides for refunds of up to 90 percent of the entrance fee.

The Vi Case

Vi is a large owner and operator of senior living communities throughout the country, formerly known as Classsic Residence by Hyatt. Residents in Vi’s communities enter into continuing care agreements that provide for lifetime care, with residents transitioning to varying levels of care depending upon need. In addition to monthly fees, residents pay entrance fees prior to occupancy. Vi is entitled to retain 2 percent of the entrance fee for each month the resident remains in the CCRC, up to a maximum of 10 percent. At least 90 percent of the entrance fee is refundable to the resident regardless of when the continuing care contract is terminated. Vi issues promissory notes to its residents for the entire entrance fee, and, upon termination of the continuing care agreement or the death of the resident, Vi would be required to repay to the resident or his or her estate the original entrance fee less the nonrefundable portion.

Although Vi characterized the refundable portion of the entrance fees as true loans for tax purposes, Vi received a Notice of Deficiency from the IRS at the end of 2009 stating that these entrance fees constitute rental income from the occupancy of its living units. As a result, the IRS contended that Vi’s taxable income for the 2005 tax year was understated by more than $327 million, and that Vi owed over $128 million in taxes and penalties.

Vi petitioned the U.S. Tax Court in response, and the IRS admitted to its position regarding the taxability of entrance fees as rental income is sound, even though it is electing not to pursue that position any longer in the Vi case. Although a prior reported decision (John O. Finzer, Jr. et ux. v. United States, 496 F. Supp. 2d 954, N.D. Ill. 2007) dealing with similar facts and a resident at a Hyatt facility in Illinois provides support for the proposition that refundable entrance fees are properly treated as loans, the IRS in the Vi case took the position that the Finzer case is distinguishable and limited based on its specific facts and the scope of the legal issues that were presented.

Vigilant Review

In view of the Vi case, it may be advisable for long-term care providers to consider reviewing the terms and conditions of their residency agreements for consistency with the provider’s characterization of the relationship for tax, accounting and regulatory purposes. In addition to complying with any applicable disclosure and regulatory requirements under relevant state law, operators using a refundable entrance fee model should be sure that the refund language is unambiguous, unconditional and properly evidences a loan transaction.

In addition, it is important to keep in mind that the timing of the refund repayment by a CCRC and the applicable triggering events are likely to be critical factors in gauging whether the IRS will consider the transaction to be a nontaxable loan. For example, some entrance fee repayment provisions may not be triggered until a new resident has re-occupied the unit or a long time period has elapsed. To the extent the prospects

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of repayment by a CCRC are made to be more remote and conditional, the IRS is apt to begin viewing the substance of the transaction as more of a taxable sale rather than a loan. Also, if the transaction does not include an outside date for the repayment to be made, the taxpayer is likely to face increased risk that the arrangement may be recharacterized.

In the Finzer case, where individual CCRC residents sought to deduct a portion of the entrance fee as medical expenses, the IRS argued and the court agreed that the entrance fee was structured as a loan. The residency agreement provided that at least 90 percent of the entrance fee would be repaid at the time the agreement was terminated, regardless of the reason for the termination, and the CCRC issued a promissory note to the residents. The only condition attached to the right to a refund was that the operator had 120 days after termination to make the payment. Similarly, the repayment provisions in the Vi continuing care contracts appear to have been relatively straightforward, reflecting a clear-cut obligation to repay the loan after the resident’s death or the earlier termination of the continuing care contract.

It is unclear whether the IRS’s posture in the Vi case is representative of a more aggressive long-term approach. In addition to the Vi case, the IRS is currently auditing the outstanding tax-exempt bonds of certain operators and alleging that investment and other restrictions should apply to the refundable portion of their entrance fees, which would also likely have significant negative financial consequences for the industry. Regardless, operators of long-term care facilities should continue to be vigilant in reviewing residency agreements and related documentation, communications and disclosures to be sure that they are clear, concise and free of potential inconsistencies and errors that could lead to tax and compliance problems in the future.

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the process for signing up. The inconsistency is causing a great deal of anxiety for eligible professionals and hospitals. Process is absolutely critical to their comfort and involvement from Day 1 of the program.

Conclusion

By the end of the year, we should have a good sense of how the Meaningful Use Incentive programs are going to work. Given the right amount of time to prepare, eligible professionals and hospitals alike will learn to adjust to the program in order to successfully complete the requirements. The concern between now and the end of the year is how many of the eligible professionals and hospitals will seek involvement. I’ll report more as I learn it. Right now, CMS seems to be caught in a policy development quagmire with very little room or time to operate. For the providers’ sake, I hope they meet the latest – and most critical – deadline!

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