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DOES THE US TAX COURT VICTORY FOR CCRC ENTRANCE FEES APPLY TO SENIOR LIVING COMMUNITY FEES?

By Paul Gordon | HansonBridgett LLP

American Seniors Housing Association

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Decision Upholds Accounting Method Favorable to the Senior Living Provider

In May 2024, the federal Ninth Circuit Court of Appeals upheld a U.S. Tax Court ruling, affirming that a continuing care retirement community (CCRC) properly recognized non-repayable entrance fees as taxable income on an incremental basis, over the actuarially projected remaining lifespan of the resident who paid them. The IRS Commissioner had claimed that taxable income should have been recognized in the first five years, when the amount of the non-repayable fee became fixed. Had the IRS's position been accepted by the courts, many millions in additional income taxes would have been due.

The difference in accounting methods can have huge consequences for the recognition of GAAP income and total taxable income. Being able to take a large initial fee into income over the lifespan of the resident, often 15 years or more, rather than in the year of receipt, or when the non-repayable amount becomes fixed, is a significant advantage for the senior living provider.

As will be explained below, the ruling was made in the context of a CCRC with large entrance fees. A key question is whether the ruling supports the same kind of accounting and tax treatment for senior living providers that charge "community fees" to their residents.

Background of the Case

The Taxpayer, which operated a full-service CCRC in Southern California had been in a dispute with the Internal Revenue Service (IRS) regarding the timing of income recognition for "Deferred Entrance Fees" ("non-repayable"). These fees are part of resident contracts, wherein 75% of the entrance fee is repayable, and the 25% non-repayable portion is set within the first five years of occumpany, at the rate of 5% per year. However, the non-repayable fee is earned by the CCRC only if it fulfills its contractually stipulated lifetime care obligation to the resident. The methodology is similar to that which typically is used by CCRCs whereby a fixed portion of the entrance fee becomes non-repayable in the first months or years after the resident takes occupancy.

The IRS challenged the Taxpayer's accrual method of accounting, which was also being utilized for tax accounting. However, the Tax Court, affirmed by the Ninth Circuit, rejected the IRS's position. The IRS has opted not to pursue the case further.

The case focused on the continued use of a Generally Accepted Accounting Principles (GAAP) method which recognizes the non-repayable entrance fee income over the life expectancy of residents, rather than reporting all fees as taxable income at the specific time when the non-repayable amount becomes fixed under the contract. In the Tax Court proceedings, the Taxpayer emphasized that the non-repayable portion of the Entrance Fee was earned and payable only if the CCRC fulfilled its contractual obligation of lifetime care.

The IRS sought to accelerate the recognition of the non-repayable Deferred Entrance Fees over the first five years of residency, arguing that this income should be taxed merely because the amount of the non-repayable Deferred Entrance Fee became known on a fixed date, fully ignoring that the promise of care for life had not yet been fulfilled. The CCRC, adhering to GAAP, recognized income from the Deferred Entrance Fees based on the life expectancy of each resident, even though the fees were not considered earned until the resident contract had been fulfilled (i.e. at move-out).

The Ninth Circuit did not accept the IRS's argument and instead confirmed that the Taxpayer's method met the "all-events test" for income recognition, complied with GAAP, and thus clearly reflected income. As such, the Tax Court found that the IRS lacked the authority to impose a different method, a decision that the Ninth Circuit has now affirmed.

Potential Applicability to Senior Living Community Fees?

The Tax Court ruling applied on its face to CCRC entrance fees, which often range in size from several hundred thousand to millions of dollars. However, other types of high-end senior living communities sometimes charge "Community Fees", that become non-repayable, which can involve similar orders of magnitude. Like Entrance Fees, Community Fees can also be refundable for a short period of time before becoming nonrefundable. If a senior living community recognizes all its Community Fee income at the time that the fee becomes nonrefundable, its income tax obligation could be substantially higher than if the fees were taken into income over each resident's actuarially-determined remaining life expectancy.

While most senior living communities that charge a Community Fee do not style themselves as CCRCs or use "Entrance Fee" terminology, there are many parallels and the GAAP treatment of recognizing fee income may be applicable. In addition to occupancy in an independent living building, some may have co-located care facilities made available to residents as their needs change.

According to the Financial Accounting Standards Board ("FASB"):

> Under provisions of continuing-care contracts entered into by a continuing care retirement community and residents, nonrefundable advance fees represent payment for future services and shall be accounted for as deferred revenue. The estimated amount of advance fees that is expected to be refunded to current residents under the terms of the contracts shall be accounted for and reported as a liability.

The Tax Court ruling emphasized the CCRC's obligation in its resident contract to provide lifetime care, consistent with FASB's accounting standards which similarly take into consideration that non-repayable Entrance Fees are advance payments for future services, earned over the resident's lifetime. Of course, CCRC contracts routinely provide that the contract may be terminated for cause prior to the resident dying or moving out of the community, such as for failure to pay monthly fees, dangerous conduct or care needs that exceed the CCRC's scope of services.

In effect, senior living communities that charge substantial Community Fees may also take on the obligation to provide services to their residents for the rest of their lives, subject to for-cause termination grounds similar to those used by CCRCs. Whether a community that charges large up-front fees is a CCRC or not is usually a technical matter of state law, which varies across the country and does not necessarily involve care for life.

If the contracts of non-CCRC senior living providers can be fashioned so that it is clear that nonrefundable payments of large Community Fees are made in exchange for future services that will be available over the time period of the resident's contract, then it well may be appropriate to recognize that income as taxable over the remaining life of the resident, rather than on receipt.

ABOUT THE AUTHOR

Paul Gordon is a partner at the San Francisco law firm of HansonBridgett LLP, and has been working with seniors housing and care providers since 1975.

Paul's entire practice is devoted to representation of seniors housing, long-term care providers, and related organizations. This includes business transactions, regulatory compliance, risk management and dispute resolution, fair housing and ADA compliance and operations counseling. He also serves as an expert witness on senior living communities in federal and state courts and arbitrations.

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