

# NMTC MONTHLY REPORT

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## Financing Nursing Homes and Assisted Living Facilities with NMTCs Part I

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Section 45D of the Internal Revenue Code (IRC) provides for a new markets tax credit (NMTC) to investors who make a qualified equity investment (QEI) into a qualified community development entity (CDE). At its most basic, IRC Section 45D further requires that the CDE make a qualified low-income community investment (QLICI) in or to a qualified active low-income community business (QALICB). Certain businesses are statutorily excluded from qualifying as a QALICB (the so-called "sin businesses"). In addition to these sin businesses, businesses that operate "residential rental property" also do not qualify as QALICBs under IRC Section 45D. If a nursing home or assisted living facility is defined as "residential rental property" for purposes of the NMTC, this provision could prevent a nursing home or other similar facility from qualifying as a QALICB.

### Residential Rental Property

Treas. Reg. § 1.45D-1(d)(5)(ii) refers to Internal Revenue Code (IRC) Section 168(e)(2)(A) to define when real property is operated as residential rental property and thus impermissible to operate as a business for purposes of the NMTC. IRC Section 168(e)(2)(A) provides that residential rental property is any real property that derives at least 80 percent of its gross rental income from rents attributable to dwelling units. According to IRC Section 168(e)(2)(A)(ii)(I), a dwelling unit is "a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, or other establishment more than one-half of the units in which are used on a transient basis." As discussed below, while the duration of a nursing home patient's stay at a facility is not always certain, the average stay is typically sufficient to render nursing home occupancy non-transient for this purpose and thus has the potential to make a nursing home room a "dwelling unit." Although the rules for tax-exempt rental housing bonds and the low-income housing tax credit exclude skilled nursing facilities from the definition of dwelling unit, for depreciation purposes there is authority under the predecessor to IRC Section 168, for a unit in a nursing home to be considered a dwelling unit.

### Gross Rental Income from Dwelling Units

If the amount of gross rental income derived from dwelling units is at least 80 percent of the total gross rental income from the property, a nursing home or assisted living facility could not qualify as a QALICB. In the context of a nursing home or skilled nursing facility, a resident's monthly payment covers medical services that typically far outweigh the rental value of the occupied unit. The same is true for an assisted living facility, although the services provided in an assisted living facility are typically less medical in nature. In either case, services may be included in the "rent" paid by the resident or they may be billed separately. Further, the operator of the facility typically occupies a portion of the facility (making use of offices, nursing stations, treatment rooms, institutional kitchens and the like) in order to provide services to the residents. Finally, businesses such as hair salons or general stores may rent and occupy space in the facility. The amount and classification of the income from these various sources will determine whether a particular facility is, or is not residential rental property.

Former Treas. Reg. § 1.167(j)-3 (prior to removal by TD 8474) provided clear guidance as to what constituted

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gross rental income and rental income from dwelling units. Unfortunately, since the IRC was amended to move many provisions (substantially unchanged) from IRC Section 167 to IRC Section 168, no similar regulations have been issued under Section 168. However, because the provisions of IRC Section 168 regarding residential rental property are nearly identical to those in former IRC Section 167, the former treasury regulations provide insight into how the rules under Section 168 should be applied.

Former Treas. Reg. § 1.167(j)-3(b)(2)(i) provided that: "the term 'gross rental income' means, generally, the gross amounts received from the use of or the right to use real property. If an amount is received with respect to property consisting of both real and personal property, such as a furnished house or apartment, that portion of the rent attributable to the personal property does not constitute gross rental income."

Further, the regulation provided that gross rental income from a building is gross rental income from a dwelling unit in such building only if it is attributable to or ordinarily associated with the use of, or the right to use, such unit as a living accommodation. See Former Treas. Reg. § 1.167(j)-3(b)(3). If pursuant to the terms of a lease or other agreement, a portion of a house or apartment is used as office space, such as a doctor's office, the rent paid with respect to such portion is gross rental income from the building but is not rental income from a dwelling unit.

The Internal Revenue Service (IRS) has applied these rules in several circumstances to determine what income earned by a nursing home is rental income and what rental income is derived from dwelling units. In Private Letter Ruling (PLR) 8239121, a nursing home facility owner requested a ruling that the facility was properly classified as residential rental property. The taxpayer represented that the facility did not consist of any commercial businesses, fewer than half of the units were used on a transient basis, and that the average stay of the residents was more than two and one-half years. The taxpayer represented that the amount attributable to the personal property furnishing each unit and the amount attributable to special services that may be provided were excluded from its determination of gross rental income from dwelling units. The IRS agreed with this approach because only the rent attributable to the use of the real property is includible in rental income from a dwelling unit. Because the taxpayer calculated that greater than 80 percent of the nursing home's gross rental income (after excluding amounts attributable to services and personal property) was attributable to dwelling units, the IRS held that, assuming the validity of taxpayers representations, the nursing home was residential rental property.

In PLR 8240067, a nursing home whose residents paid a basic

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room charge that covered living accommodations, full board, nursing services and housekeeping was determined to be residential rental property. In that PLR, additional services, including speech and physical therapy, were available to the residents on site, but were billed separately. In addition, a beauty salon paid a *de minimis* amount of rent to the owner to occupy a small space in the facility. The IRS agreed with the taxpayer that the amounts paid as rent but attributable to special services such as housekeeping and nursing services must be excluded from the amount of gross rental income because such services are not customarily rendered in connection with the mere rental of rooms. Therefore, relying on former Treas. Reg. § 1.167(j)-3(b)(3) and based solely upon the taxpayer's representations, the IRS concluded that because only the rental income from dwelling units and not that attributable to the additional services or the hair salon were included in the taxpayer's calculation, that at least 80 percent of the nursing home's gross rental income was attributable to dwelling units, the property was residential rental property.

In PLR 9825024, the residents of a nursing home paid a basic charge to the operator that covered living accommodations, full board, nursing services, laundry, housekeeping, utilities, general nursing supplies, activities and social services. Any additional services available on the premises for the residents of the facility were billed separately and no stores or other commercial enterprises were present. The residents' average stay was about one year. The taxpayer determined that at least 80 percent of the home's gross rental income was attributable to dwelling units as follows:

1. only amounts received from the use of or the right to use real property are included in gross rental income and rental income from dwelling units;
2. amounts attributable to the rental of any personal property located in the individual units of property are excluded from gross rental income and rental income from dwelling units;
3. amounts attributable to the furnishing of services for the residents of the property that are usually or customarily attributable to the use of or right to use real property are included in gross rental income and rental income from dwelling units;
4. amounts attributable to the performance of significant services for the residents of the property other than those customarily rendered in connection with the mere rental of rooms are not included as gross rental income or rental income from dwelling units; and
5. the rental at which a vacant unit is offered is not included in gross rental income or rental income from a dwelling unit.

Again, the IRS agreed with the taxpayer's methodology and determined that the property was residential rental property. It is important to note that the fact that each ruling cited above found that the nursing home at issue was residential rental property is not coincidental. Residential rental property is depreciated over a shorter period of time than nonresidential

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real property. Accordingly, taxpayers have consistently sought rulings in cases where the facts are favorable to have nursing homes be deemed residential rental property. Accordingly, neither the taxpayer nor the IRS in these rulings was interested in the characterization of the income that had been excluded from dwelling unit income.

What these rulings reveal is that when determining the rental income of the premises attributable to dwelling units, special services not customarily provided to residential tenants must be carved out of the calculation of rental income attributable to dwelling units. In the context of a nursing home or assisted living facility, the income from these services may be significant. However, subject to the discussion in part two of this article regarding owner-occupied facilities, the service income must also be earned by the QALICB owner as commercial rent to be part of the formula for determining what percentage of the facility's total gross rental income is attributable to the rental of dwelling units. ❖

**Next Month:** In part two of this article, we will discuss strategies for structuring commercial services income and related guidance.

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