

NMTC MONTHLY REPORT

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Financing Nursing Homes and Assisted Living Facilities with NMTCs Part II

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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.

Last month, in part one of this article, we discussed relevant sections of Treasury Regulations and several private letter rulings. This month we continue with a look at strategies for structuring commercial services income and related guidance.

Structuring Commercial Services Income

In certain circumstances, nursing or supportive services may be provided by an outside service provider who leases space within the building. In this case, as with the hair salon described in PLR 8240067, the rental income earned by the facility owner from the service provider would be commercial rental income. Accordingly, if a service provider were to lease space in a facility at a rent level that resulted in the rents from the dwelling units being less than 80 percent of the total gross rental income (including the commercial rent), the nursing home facility would not constitute residential rental property. In such a case, the service provider would presumably be willing to pay commercial rent in an amount projected to leave the

service provider with a net profit after collecting expected service income from the residents.

As an alternative to leasing space within the facility to an outside service provider to provide the additional services that nursing homes or assisted living facilities provide, the owner itself could provide these services from space that it occupies within the facility. IRC Section 168(e)(2)(A)(ii)(II) provides that "if any portion of the building or structure is **occupied by the taxpayer, the gross rental income** from such building or structure shall include the **rental value** of the portion so occupied." As discussed in part one, because former IRC Section 167 contained a similar provision, former Treas. Reg. Section 1.167(j)-3 provides instructive guidance.

Former Treas. Reg. §1.167(j)-3(b)(4)(iii) provided that:

If any portion of a building or structure is occupied by the taxpayer, the fair rental value of such portion shall be included in gross rental income in determining whether the building or structure qualifies as residential rental property. Thus, if the taxpayer uses space in the building for the operation of a drugstore, the fair rental value of the space is treated as gross rental income from the building but not as rent from a dwelling unit.

The former regulation also provides an example of the taxpayer operating a commercial store in its building. The fair rental value of the store is included as non-dwelling unit rental income in the determination of whether the 80 percent threshold is met. (See Example 2 of Former Treas. Reg. §1.167(j)-3(b)(6).)

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The IRS provided very similar guidance in chief counsel advice (CCA) 200526002. There a taxpayer sought to depreciate a portion of his apartment unit (which was one of eight dwelling units in the apartment building) as residential rental property despite the presence of a home office in his unit. The IRS stated that the example from former Treas. Reg. §1.167(j)-3(b)(6) referenced above:

show[s] that if a building or structure is used to provide living accommodations on a rental basis and if any portion of that building or structure is occupied by the taxpayer, the fair rental value of the portion occupied by the taxpayer as a residence is treated as gross rental income from the building and as rental income from dwelling units and that the fair rental value of the portion occupied by the taxpayer for a commercial activity (such as operating a store) is treated as gross rental income from the building but not as rental income from dwelling units.

The IRS stated that because the rental value of the home office did not exceed 20 percent of gross rental income from the dwelling units in the building, any depreciable portion of the taxpayer's unit was properly depreciable as residential rental property.

Accordingly, it appears that owner-occupied space **valued at its fair rental value** is includible in a facility's total gross **rental income**. In the context of a nursing home or assisted living facility, assuming that the owner of the building occupies space of sufficiently high fair rental value, the rents attributable to dwelling units may not equal or exceed 80 percent of the total gross rental income and the facility would not constitute residential rental property. An appraisal would be necessary to support the determination of the fair rental value of the commercial space (offices, conference rooms, treatment rooms, staff lounges and lunchrooms, kitchens, nursing stations) in the facility. Presumably the valuation would be based on a combination of what a third-party service provider would be willing to pay for the space in exchange for the right to receive service income from the provision of services to the residents (which may be significant income) and what comparable dwelling units might be rented for in the market if no services were provided (i.e., a studio apartment in a senior apartment building).

The precise structure that will work best will also be dependent on whether Medicaid, Medicaid Home and Community-Based Waiver programs, or other reimbursement or subsidy programs will permit the division of payments from or with respect to occupants into a rent component payable to the owner and a service component payable to a service provider. If programmatic requirements prohibit this split, the owner-occupied approach may be the only solution.

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It should be noted that one result of structuring a facility so that it qualifies as commercial rental property is that, while an NMTC investment may be permitted, the facility owner will lose the right to depreciate the real property as residential rental property for a 27½-year life. Instead, it will be required to treat the property as nonresidential real property with a 39-year depreciable life.

In conclusion, using the NMTC to provide financing to a nursing home or assisted living facility presents several unique challenges that require careful consideration. However, in many instances by structuring the transaction with the foregoing discussion in mind, nursing homes and other skilled nursing facilities will qualify as QALICBs eligible to receive the benefits of NMTC financing. ❖

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