

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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to: Senior Counsel
(Large Business & International), CC:LB&I:RFPH:CH2M

from: Branch Chief, Branch 7
(Income Tax & Accounting), CC:ITA:7

subject: Continuing Care Retirement Community facilities as Residential Rental Property
POSTF-143802-10

LEGEND

Taxpayer =

Owner =

X =

Y =

Date =

Type One =

Type Two =

Year =

a =

b =

Option A =

Option B =

Option C =

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

1) Did Taxpayer properly treat its Type One Community facilities as residential rental property with a recovery period of 27.5 years for purposes of § 168(a) of the Internal Revenue Code?

2) Did Taxpayer properly treat its Type Two Community facilities as residential rental property with a recovery period of 27.5 years for purposes of § 168(a)?

CONCLUSIONS

1) Taxpayer properly treated its Type One Community facilities as residential rental property with a recovery period of 27.5 years for purposes of § 168(a).

2) Taxpayer properly treated its Type Two Community facilities as residential rental property with a recovery period of 27.5 years for purposes of § 168(a).

FACTS

Taxpayer is controlled by Owner. Taxpayer operates retirement communities as described further below.

During the years at issue, Taxpayer did business as X. On Date, it changed the name of the business to Y. Taxpayer owns and operates retirement communities for a senior/elderly clientele. Taxpayer operates these communities as either a Type One Community or as a Type Two Community. As of the end of Year, Taxpayer owned and operated a total of a Type One Communities and b Type Two Communities. Taxpayer depreciates the facilities under both types of operations as residential rental property with a recovery period of 27.5 years.

More than 50 percent of the units in both Taxpayer's Type One Communities and Taxpayer's Type Two Communities are occupied on a non-transient basis.

1. Type One Communities

A Type One Community offers a housing unit, personal and social services, and various levels of health care for the life of the resident. Taxpayer's Type One Communities

generally offer lifetime care from independent living to nursing home care on a single campus.

Most of the Type One Community contracts fall into three categories. Option A contracts provide care for residents for the rest of their lives without significantly increasing their monthly fees. Option B contracts provide a certain number of free days in assisted living or nursing homes, then charge for additional care. With Option C contracts, residents pay more anytime they need additional care.

Independent living, assisted living, Alzheimer's/memory support care, and skilled nursing care are living options provided by Taxpayer's Type One Communities. According to Taxpayer's web site, independent living includes a "maintenance-free home combined with an array of social and recreational opportunities." Some housekeeping, laundry, and transportation services are also provided. The Type One Community staff, including licensed nurses, help monitor assisted living care. In the Assisted Living programs, assistance is provided with regard to "activities of daily living based upon each resident's plan of services and care". The Alzheimer's/memory support care program provides supportive care to residents with mild to moderate Alzheimer's or similar cognitive conditions. The skilled nursing care program serves individuals recovering from injury or illness, requiring concentrated rehabilitation, or needing long-term nursing care.

Generally, a retiree entering into a Type One Community receives an independent living housing unit. The community offers access to the various living options aging may require. With the passage of time and as needs arise, the individual may go from independent living to assisted living, memory support care, and skilled nursing care, as well as back to more independent living as health improvements may allow. A resident moving to a new living program pays "the same monthly fee charged for his or her independent living home, plus charges for extra meals and ancillary items." A resident will move among different housing units as the resident moves among the different living programs.

Type One Community residents do not purchase a residence, nor do they enter into a lease. Instead, Taxpayer and the resident enter into a continuing care agreement. The resident pays a substantial entrance fee and a substantial monthly fee. For the years at issue, a portion of the entrance fee is refundable upon a resident's moving out of the facility or dying. Certain other conditions may apply before Taxpayer repays the refundable portion of the fee.

There are certain situations that may permit Taxpayer to terminate the agreement and remove the resident from the facilities, such as a situation in which a resident is unable to pay the required fees as a result of his or her wasting assets through irresponsible gambling. However, if the resident merely outlives his or her resources, Taxpayer can use the refundable portion of the resident's entrance fee to cover fees, and the resident will not be removed.

The monthly fees charged to Taxpayer's Type One Community residents are greater than the market rates to rent a comparable housing unit. Services covered by the monthly fees include maintenance of building and grounds, weekly light house cleaning, and laundering of bed linens. The community offers other services, some of which are provided at no cost to residents and some of which require payment of an additional fee.

Taxpayer does not characterize any portion of the monthly fees as rent. In reporting income, Taxpayer describes the monthly fees as life care services income (and not as rent).

2. Type Two Communities

Taxpayer's Type Two Facilities are senior retirement communities similar to Taxpayer's Type One Communities, however, no upfront entrance fees are charged. The residents sign renewable annual leases. These facilities offer similar services to the Type One Communities except that residents must pay on a monthly fee basis additional charges for any onsite assisted living, personal care, or Alzheimer's disease care.

These facilities operate under the original name of X. In reporting income, Taxpayer describes the monthly fees as life care services income (and not as rent).

LAW AND ANALYSIS

Section 167(a) allows as a depreciation deduction a reasonable allowance for the exhaustion, wear, tear, and obsolescence of property used in a trade or business. Section 168(a) provides that the depreciation deduction provided by § 167(a) for any tangible property placed in service after 1986 must be determined using the applicable depreciation method, the applicable recovery period, and the applicable convention. Only the applicable recovery period is at issue in this case. Section 168(c) assigns recovery periods of 27.5 years and 39 years to residential rental property and nonresidential real property, respectively, for purposes of the general depreciation system of § 168(a).

Section 168(e)(2)(B) defines nonresidential real property as § 1250 property that is not residential rental property or property with a class life of less than 27.5 years.

Section 168(e)(2)(A)(i) defines residential rental property as any building or structure if 80 percent or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units. If any portion of the building or structure is occupied by the taxpayer, the gross rental income from the building or structure includes the rental value of the portion occupied by the taxpayer. Section 168(e)(2)(A)(ii)(II).

Section 168(e)(2)(A)(ii)(I) provides that a dwelling unit means 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.

Prior to the enactment of the Omnibus Budget Reconciliation Act of 1990, § 168(e)(2)(A) provided that the term “residential rental property” has the meaning given such term by § 167(j)(2)(B). See also section 3.02(2) of Rev. Proc. 87-57, 1987-2 C.B. 687, 689. Section 167(j) and (k) (stricken by the Omnibus Budget Reconciliation Act of 1990) contained definitions of the terms “residential rental property” and “dwelling unit” substantially identical to the definitions in § 168(e)(2). Former § 167(j)(2)(B) defined residential rental property as a building or structure of which 80 percent or more of the gross rental income for the building or structure is rental income from dwelling units within the meaning of former § 167(k)(3)(C). The definition of dwelling unit in former § 167(k)(3)(C) is the same definition given that term in § 168(e)(2)(A)(ii)(I).

While former § 167(j) and (k) does not apply to property placed in service after November 5, 1990, the guidance issued under former § 167(j) and (k) remains informative for determining whether a building or structure qualifies as residential rental property under § 168(e)(2)(A).

Former § 1.167(j)-3(b)(2)(i) of the Income Tax Regulations provided that the term “gross rental income” means, generally, the gross amounts received from the use of, or the right to use, real property. The gross amount attributable to the furnishing of services that are usually or customarily attributable to the use of, or the right to use, real property constitutes gross rental income from the building. However, the gross amount attributable to the performance of significant services for the occupant that are other than those usually or customarily rendered in connection with the mere rental of rooms, such as maid service, does not constitute gross rental income from the building. See former § 1.167(j)-3(b)(2)(iii). Consequently, income attributable to services other than those usually or customarily rendered in connection with the mere rental of rooms is excluded both from rental income from dwelling units (the numerator) and from gross rental income from the building (the denominator) for purposes of the 80 percent gross rental income test under § 168(e)(2)(A)(i).

In accordance with former § 1.167(j)-3(b)(3), 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. The right to use a parking space or swimming pool is ordinarily associated with the right to use a dwelling unit as a living accommodation. Accordingly, an amount paid by a tenant of a dwelling unit for such a parking space or swimming pool is gross rental income from a dwelling unit. If a portion of the building is used for a drugstore, grocery store, commercial laundry, or other commercial operation, the rent paid for such portion (including any amount paid for services in connection with such a commercial operation) is not rental income from a dwelling unit. 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 for that portion is gross rental income from the building but is not rental income from a dwelling unit.

If any portion of a building or structure is occupied by the taxpayer, former § 1.167(j)-3(b)(4)(iii) provided that the fair rental value of that portion is included in gross rental income in determining whether the building or structure qualifies as residential rental property. The examples in former § 1.167(j)-3(b)(6) showed 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 a dwelling unit, 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 a dwelling unit.

Former § 1.167(k)-3(c)(1) provided that the term "dwelling unit" means a house or apartment used to provide living accommodations in a building or structure. It is not required that the dwelling unit be occupied subject to a lease. According to GCM 35648 (Feb. 4, 1974), the authors of former § 1.167(k)-3(c)(1) intended that the term "dwelling unit" encompass nursing homes, old age homes, and college dormitories.

Former § 1.167(k)-3(c)(2) provided that the term dwelling unit does not include any unit in a hotel, motel, inn, or other establishment more than one-half of the dwelling units in which are used on a transient basis. A dwelling unit is used on a transient basis if for more than one-half of the days in which the unit is occupied on a rental basis during the taxpayer's taxable year it is occupied by a tenant or series of tenants each of whom occupies the unit for less than 30 days.

Section 168(e)(2)(A) defines property as a residential rental property by reference to a "building or structure," not to a dwelling unit or a portion of a dwelling unit. For a building or structure to be residential rental property, it must contain at least one dwelling unit that is actually rented to provide living accommodations. If the building or structure satisfies this threshold test, then the 80 percent gross rental income test is applied.

Taxpayer characterizes all of the income it receives from residents of its facilities as income from life care services and not as rent, even in the case of the annual leases required in Taxpayer's Type Two Communities. However, this subjective characterization does not dictate whether the property is residential rental property for purposes of § 168.

Residents of Taxpayer's Type One and Type Two Communities utilize the residential units therein as living accommodations. Part of the benefit accorded under the contract between Taxpayer and the residents of a Type One or Type Two Community is the right

to occupy and reside in a particular residential unit. Although a resident may move between Taxpayer's facilities as the resident's needs change, and therefore between residential units, the resident nonetheless may generally expect to retain the same residential unit continuously until such time arises. This right is one of several rights that the resident obtains and pays for under the service agreement with Taxpayer. Consequently, some allocable portion of the monthly amount received by Taxpayer is payment for the use of, or the right to use, a dwelling unit, and constitutes rental income from that dwelling unit for purposes of applying the 80 percent gross rental income test under § 168(e)(2)(A)(i).

The fact that residents in Taxpayer's Type One Communities occupy residential units without a formal lease is not dispositive. See former § 1.167(k)-3(c)(1). Similarly, the state law authorities cited in your submission, such as the result in Jackim v. CC-Lake, Inc., 363 Ill. App. 3d. 759, 842 N.E.2d 1113 (2005), that "the relationship between a life care provider and a life care facility is distinguishable from the traditional landlord-tenant agreement" and that "life care contracts are not leases within the meaning of the interest statute" are not dispositive, as § 168(e)(2)(A) does not require a landlord-tenant relationship or the existence of a lease, but only that income is received from the rental of dwelling units.

The various types of residential units (independent living, assisted living, Alzheimer's/memory support care, and skilled nursing care units) within the buildings that comprise Taxpayer's Type One and Type Two Communities are used to provide living accommodations, and are not units in an establishment more than one-half of the units in which are used on a transient basis. Therefore, these residential units are dwelling units for purposes of § 168(e)(2)(A). Nothing in the facts provided indicates that Taxpayer receives non-residential rental income from third parties, or that Taxpayer conducts commercial activities in a significant enough portion of these buildings to cause Taxpayer to fail the 80 percent gross rental income test. Thus, in this case, the buildings utilized to provide living accommodations to residents in both Taxpayer's Type One Communities and Taxpayer's Type Two Communities are residential rental property under § 168(e)(2), and Taxpayer should determine depreciation for the buildings within Taxpayer's facility containing dwelling units utilized by the residents (but not for any buildings within the facility that are owner-occupied) over a 27.5 year recovery period for purposes of § 168(a).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Nothing in this advice should be interpreted as suggesting that any part of the entrance fee paid by a resident should be treated as rental income unless and until such time as, and only to the extent that, a portion of the entrance fee is consumed and taken into income in lieu of payment of the monthly fee due under the continuing care agreement between Taxpayer and the resident.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-4930 if you have any further questions.

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