Advising Clients about Continuing Care Retirement Communities (CCRCs)

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ABSTRACT

We look at the types of contracts offered by continuing care retirement communities (CCRCs), the tax treatment of the entrance and monthly fees, entrance-fee refunds, and the importance of a conversation with a client before they enter a CCRC.

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There are approximately 2,000 continuing care retirement communities (CCRCs) housing upwards of 600,000 residents in the United States.[1] CCRCs are professionally managed retirement communities that provide a continuum of life-care options on a single campus. Most residents begin in independent living where they are offered apartment or cottage-style living with social activities, lifestyle amenities, and meal plans. As their health needs change, residents may transition to assisted living, memory care, or receive skilled nursing care within the facility's medical center.

With the U.S. elderly population expected to double over the next 25 years, planners can expect an increasing number of client requests to help them plan for one of the most significant investments they will make during their lifetime.[2] Understanding the types of contracts offered by CCRCs and their tax implications is critical to helping clients make well-informed decisions regarding the long-term agreements they execute with their community.

Types of CCRC Contracts

The majority of CCRCs require residents to pay an up-front entrance fee in addition to a monthly fee. The entrance fee will typically vary depending on the size of the living unit the client selects, and whether the client elects to have a portion of the entrance fee refunded when they leave or die. Common entrance-fee refunds are 90 percent or 50 percent, while some communities offer a declining balance refund (i.e., 2 percent a month declining balance until the entrance fee is depleted). The monthly fee is usually set in the contract and may be adjusted to cover increased operating or general cost-of-living expenses.

The three types of contracts typically offered by CCRCs are Type A, Type B, and Type C.

Type A: Life-Care

Under a Type A contract, the resident's housing, residential services, and use of amenities is covered. Of the three types of contracts, Type A will have the highest entrance and monthly fee, because the resident is signing a life-care contract with the community that allows them unlimited use of either assisted living or nursing home care if their health needs change. Essentially, they are prepaying for any future health-related care.

While the costs incurred by the CCRC will increase as the resident moves from independent living to higher levels of care, the individual should see little or no increase in their monthly costs. It is important to know that by signing a life-care contract, the individual is transferring the potential risk of a long-term care (LTC) need to the facility. As a result, the individual/couple will need to be in relatively good health prior to signing the contract, or they may be denied entrance or be required to execute a Type B or C contract, if offered.

Type B: Modified

Also known as modified contracts, Type B provides the same benefits of a Type A contract with limits on the amount of assisted living or skilled nursing care that may be accessed without an increase in the monthly fee. Residents may have access to a predefined number of care days before they have an increase in their monthly fees. Typically, once the resident exhausts their allotted number of care days, they will pay for care at a reduced rate in relation to open-market rates. Type B contracts should have lower monthly fees than Type A contracts.

Type C: Fee for Service

With a Type C contract, the same benefits that are provided to residents under a Type A contract are usually included, with the exception that residents are required to pay for assisted living or nursing home care at the facility's market rates. Essentially, the resident retains the risk of a LTC expenditure rather than transferring the risk to the CCRC. The Type C contract will have the lowest entrance and monthly fees of the three available contracts.

Tax Treatment of Entrance and Monthly Fees

The Internal Revenue Code allows a deduction for medical expenses paid by an individual during the taxable year as an itemized deduction, to the extent that such expenses exceed 10 percent of adjusted gross income.[3] Included in the definition of eligible medical care are qualified LTC services.[4]

Fortunately for the residents of CCRCs, the entrance and monthly fees incurred are deductible to the extent that they represent a prepayment for future assisted living or nursing home care. This has been established by multiple IRS rulings. It is important to note that according to the IRS, the resident must enter into a life-care or modified contract (Type A or B) to claim the deduction.[5]

There are two common methods based on IRS rulings that can be utilized to determine the dollar amount of entry and monthly fees that are deductible.

Percentage Method

In IRS rulings 76-481, 67-185, and 75-302, it states that although medical services may not be provided until years into the future, if the CCRC can reasonably estimate the operating costs of the memory, assisted living, and nursing home units as a percentage of the total cost of operating the community, the percentage may be applied to the entrance and monthly fee of the resident to determine the amount of medical expense deductions available.

As indicated earlier, the entrance and monthly fees may vary due to the size of the unit the resident selects. As a result, the IRS has pushed, in some cases, for a per-capita allocation when applying the percentage method. This requires the CCRC to use the weighted average entrance fee (total entrance fees collected divided by the number of new residents entering that year) and monthly fees paid by all residents when calculating the percentage-of-fee allocation.

Actuarial Method

The actuarial method provides another option for a CCRC to calculate the prepaid medical expenses associated with the entrance and monthly fees. With this method, the annual subsidy required to run the assisted living and nursing home portions of the community is divided by the total number of independent living residents. The result is then multiplied by the average life expectancy of independent living residents to provide lifetime total costs of medical care.

In *Baker v. Commissioner,* 122 T.C 143 (2004), the Tax Court ruled that while the more complicated actuarial method is not required, it is a valid method for estimating the costs of medical care included in entrance and monthly fees.

Entrance-Fee Refunds

In the event that the client signs a contract with a refundable entrance fee, any deductions taken as a medical cost for the entrance fee would generally need to be recognized as income in the year of the fee refund.[6] If the entrance fee is refunded due to death, the refund would be included in the estate of the deceased, but it would not be recognized as income in respect of a decedent.

With some CCRC contracts, the guarantee of an entrance-fee refund may be considered a loan by the resident to the CCRC. In a 2007 tax court case, *Finzer v. United States,* it was established that an entrance fee could be deemed a loan. As a result, no medical expense deduction would be available to the taxpayer.

Important Client Conversations before They Enter a CCRC

It is common for retirees to want to remain in their primary residence for as long as possible. As a result, many retirees will wait until their late 70s or early 80s before electing to move into a CCRC. However, planning for the possible transition to a CCRC should begin early in retirement or before.

As discussed earlier, for an individual or couple to qualify for a life-care contract at a CCRC, they must be in relatively good health. Without securing some form of LTC insurance prior to entering the CCRC, the client incurs the risk that they may be forced to pay out-of-pocket at market rates for an early-onset, LTC requirement. As a result, a significant number of clients will need to make a decision between keeping their LTC insurance combined with a Type C, fee-for-service contract, or possibly letting their LTC coverage lapse and secure a Type A (life-care) contract from the CCRC.

The following are some of the items that planners and their clients should consider when making this decision.

Tax Advantages of Type A Contracts

There are significant tax advantages to a Type A contract versus a Type C, fee-for-service contract. It is not uncommon to see approximately 20 to 40 percent of the entrance and monthly fees deducted using the percentage or actuarial method. The following is an example for a couple:

Entrance Fee	$450,000
Percentage-Method Deduction	30%
Entrance-Fee Deduction	$135,000
Monthly Fee	$6,000
Percentage-Method Deduction	30%
Monthly-Fee Deduction	$1,800

In year one of residency, the couple would have a medical-expense deduction subject to the 10 percent floor of $156,600 [$135,000 + ($1,800 x 12)]. Even a client with $500,000 of adjusted gross income would recognize a deduction in excess of $100,000. In subsequent years, they would be able to continue deducting the applicable percentage of the monthly fees attributable to prepaid health care.

In contrast, a client electing a Type C contract who pays a slightly reduced entrance and monthly fee receives no tax deduction. If they are paying premiums on a long-term care policy, their deduction is limited to $5,270 per individual or $10,540 for a couple, subject to the 10 percent floor for 2019.

Advantages of Type A Contracts versus Type C Combined with LTC Insurance

Most Type C contracts combined with LTC insurance will have inherent disadvantages when compared to a Type A (life-care) contract with a CCRC. The following are some items to consider.

It is rare for a client to have a LTC policy with an unlimited benefit period. However, with a life-care contract, the resident has essentially purchased a lifetime LTC benefit, thus eliminating the possibility of running out of assisted living or nursing home coverage.

Another significant advantage of a life-care contract is the lack of an elimination period. While most LTC policies typically have an elimination period of 30 to 180 days for assisted living or nursing home coverage, the resident with a life-care contract moves to higher levels of care without usually incurring any additional costs.

Other than the potential increases in monthly fees from the CCRC, the risk of LTC inflation is also borne by the CCRC. With an LTC policy, the inflation rider must be included, and it is possible that the rate of inflation for assisted living or nursing home care may increase at a rate higher than that included in the LTC policy.

The individual in a CCRC may have an easier time qualifying for care in their CCRC's assisted living or nursing home facilities than the individual making a claim on an LTC policy. The CCRC will have a better understanding of the health issues facing a resident than an insurance company reviewing a person's medical records with nothing more than a brief in-person interview with a medical claims manager.

Disadvantages of Type A versus Type C Contract Combined with LTC Insurance

Unlike an insurance company, there is no mandatory membership in a state guaranty association for CCRCs, nor is there any federal backstop such as banks have with the FDIC. As a result, the possibility of bankruptcy, while rare, is an inherent disadvantage of committing to a CCRC utilizing a Type A contract. Before committing to a CCRC, the planner should advise their client to review the financial health of the organization, taking into consideration net assets, occupancy rate, maintenance records, actuarial computations, accreditation, and indebtedness.

What happens if a client contractually commits to a CCRC only to find out that they are unhappy in the facility, or their family/children move across the country? Provided that they have a refundable entrance fee, a Type C contract will provide them with greater flexibility and freedom to move locations. They will continue to have LTC protection through their LTC policy and will be free to find another community better suited to their needs or location.

LTC policies will usually have an advantage over the Type A contracts when a client goes onto claim, because most LTC policies will include a waiver of premium. Under a Type A contract with a CCRC, the resident must continue to pay their monthly fee, even when they receive assisted living or nursing home care.

Conclusion

For most individuals entering a continuing care retirement community, it will likely be their last home and one of the most impactful decisions they will make in their lifetimes. Choosing the correct type of contract may provide thousands of dollars in savings for clients, and also ensure that they have adequate coverage to meet their potential LTC needs. CCRCs are unlikely to provide significant guidance and advice in regard to the complex contracts they offer; especially regarding the tax implications. As a result, the financial planner, in conjunction with the client's accountant and attorney, can play a critical role in helping them evaluate contracts, implement savings strategies, and make sure the community the client is entering is financially sound. ■

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(1) "Snapshot! Senior Living Stats and More," *Ziegler.com,* January 29, 2018; accessed at: https://www.ziegler.com/z-media/3748/sl_znews_012918.pdf. Also, Ashlea Ebeling, "Continuing Care Communities: A Big Investment with Catches," *Forbes,* September 26, 2011; accessed at: https://www.forbes.com/sites/ashleaebeling/2011/09/26/continuing-care-communities-a-big-investment-with-catches/#406ad6e837ad.

(2) Geraldine Sealy, "U.S. Elderly to Double in 25 Years," *ABC News,* accessed February 15, 2019, at: https://abcnews.go.com/US/story?id=91943&page=1.

(3) See IRC Sec. 213(a).

(4) See IRC Sec. 213 (d)(1)(c).

(5) Rev. Rul. 93-72.

(6) Rev. Rul. 75-302, 76-481.