

# Deducting the Cost of Life in a Retirement Community



**Marc J. Soss, Esq.**  
Licensed in Florida,  
Connecticut & Rhode Island

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Many individuals in our aging population are transitioning from home ownership to life in a continuing care retirement community (CCRC). To enter a CCRC, an individual will pay a one-time entry fee and ongoing monthly charges for housing and services (meal plans, housekeeping, transportation, and social and recreational activities). The benefit of a CCRC is that when a resident's health and personal care needs become more acute, they are not forced to move to a new facility, as their level of service can be increased to include assisted living, long-term care and skilled nursing care.

Although the costs of a CCRC can be substantial, a percentage of the costs can be deducted as a medical expense income tax deduction either by the individual or third party if they are providing more than half of the resident's support.

## **Supporting Tax Law:**

Section 213(a) of the Internal Revenue Code (IRC) allows as a deduction any expenses that are paid during the taxable year for the medical care of the taxpayer, his or her spouse, and dependents who are not compensated by insurance or otherwise. *Estate of Smith v. Commissioner*, 79 T.C. 313, 318 (1982). The deduction is allowed only to the extent the amount exceeds 7.5 percent of adjusted gross income. Sec. 213(a); sec. 1.213-1(a)(3), Income Tax Regs. For purposes of Sec. 213 the term "medical care" includes amounts paid "for the diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure or function of the body."

Support for the medical expense deduction is derived from the 2004 U.S. Tax Court decision of *Delbert L. Baker v. Commissioner*, 122 TC 143, 2004. In *Baker*, the taxpayers resided in an upscale California CCRC. On their income tax returns, the Bakers claimed medical expense deductions equal to about 27% of their first-year entry fee and about 40% of their monthly fees. The IRS denied a large percentage of the Baker's claimed deductions, and the couple took the case to the Tax Court and mostly won, losing only with respect to their attempt to claim medical deductions for expenses allocable

to the CCRC's swimming pool, spa, and gym.<sup>1</sup> The Tax Court ruled that the amount of CCRC fees that can be treated as medical expenses for tax purposes depends only upon the CCRC's aggregate medical expenditures in relation to its overall expenditures or overall revenue from fees paid by its residents.

Over the past forty-five years, the Internal Revenue Service (IRS) has issued numerous Revenue Rulings pertaining to the issue of whether the portion of a monthly fee paid by individuals in connection with their residence at a retirement home under a lifetime care contract was deductible by the individuals as an expense for medical care under section 213.<sup>2</sup> In each ruling, the individual was able to substantiate their argument that a portion of the monthly fee was for costs of providing medical care, medicine, and hospitalization.

## **Types of CCRC's and Calculation of Medical Expense Deduction:**

There are three basic types of CCRCs, each categorized by the amount of healthcare covered in the resident agreement and how and when the resident pays for the healthcare. The categories are: Type A (extensive contract), Type B (modified contract), and Types C and D (fee-for-service contracts). The cash outflows associated with these options are entrance fees and monthly fees. The category of the facility will affect the tax consequences for the resident.

The medical expense deduction can be calculated by the percentage method or the actuarial method. While the IRS supports use of the actuarial method based on healthcare utilization and longevity, the Tax Court in *D.L. Baker v. Comm'r*, 122 TC 143 (2004), upheld the use of the percentage method calculated on an allocation percentage based on the number of community residents and the weighted-average monthly service fees. The CCRC is responsible for determining the amount of the entrance fee and the monthly fee that should be allocated to prepaid healthcare.<sup>3</sup>

The definition of the term "chronically ill" will determine the deductibility of a resident's monthly assisted-living fees.<sup>4</sup> Certain tax deduc-

tions are only available if the resident enters a CCRC as a chronically ill individual instead of for basic custodial care. To qualify as chronically ill, an individual must be certified by a licensed healthcare provider as unable to perform (without substantial assistance) at least two "activities of daily living" (eating, toileting, transferring, bathing, dressing, and continence) for at least 90 days due to a loss of functional capacity, or must require substantial supervision for protection due to severe cognitive impairment.

### **Additional Tax-Planning Opportunities**

An individual planning their transition to a CCRC can obtain additional tax planning benefits by timing the payment of their entrance fee and liquidation of their investments to pay the fee. A combination of the tax-deductible portion of the entrance fee and monthly fees attributable to healthcare may result in significant itemized deductions. The deductions may reduce the individual's taxable income to a level that will result in their capital gains and qualifying dividends being taxed at the lower rate (5% instead of 15%).

### **Conclusion**

The portion of both an individual's entrance fee and monthly fee, which are paid in return for being provided medical care, are a deductible expense in the year paid. The expense will be allowed only to the extent the amount exceeds 7.5 percent of the individual's adjusted gross income, as prescribed in IRC Section 213.

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#### **ENDNOTES**

1 *These types of expenses are only deductible if they are necessary for a specific medical condition or illness. Expenses that simply promote general health and fitness cannot be deducted as medical costs.*

2 *Rev. Rul. 67-185, 1967-1 C.B. 70, Rev. Rul. 75-302, 1975-2 C.B. 86, and Rev. Rul. 76-481, 1976-2 C.B. 82.*

3 *For purposes of the computation of the ratio of medical to total expenses, the medical expenses include salaries of the Medical Center staff, incidental medication and supplies, the proportionate amount attributable to the provision of medical care of housekeeping, maintenance, utilities, administrative and marketing costs, interest on indebtedness, real estate taxes and depreciation of the nursing facility.*

4 *IRC Section 7702B(c) and Notice 97-31. ❖*