



122 Tax Court Ruling Number 8

Demystifying Prepaid Medical Deductions

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Overview

- ◆ Issues
- ◆ Case 122 Tax Court No. 8
- ◆ Role AVP as expert witness
- ◆ Actuarial method to calculate prepaid medical
- ◆ Air Force Village West (“AFVW”) case study
- ◆ Conclusions

Issues

- ◆ IRS Code, Section 213(a) does allow deduction for prepayment of medical care costs
- ◆ Code does not:
 - ✓ Define deductible medical care in a CCRC
 - ✓ Suggest method for calculation of
 - annual deduction from monthly fee
 - one-time deduction from entrance fee
 - ✓ State whether assisted living or home care should be considered a deductible expense

CCRCs Practices

- ◆ Private letter rulings about deductions from:
 - ✓ Monthly fees
 - ✓ Entry fees
- ◆ CFOs generated information on health care costs
 - ✓ Used to calculate deductible amounts
 - ✓ Initially only SNF usage
 - ✓ Later included ALU if medical versus social model
- ◆ Most CCRCs apply the “percentage” method

Percentage Method

- ◆ **Theory**—at any point in time for a group of contractholders, the relationship between medical costs for a the group and their total costs corresponds to the portion of their fees that are attributable to medical care
- ◆ **Rationale**—if entry plus monthly fees are set to covers all costs, then it must be true that the percentage of those fees attributable to health equals the relationship between medical costs and total costs

How Has It Worked in Practice?

- ◆ Anecdotal evidence suggests that most CCRC residents rely on recommended percentage
- ◆ Rarely challenged by IRS if:
 - ✓ Percentage not significant outside range observed by reviewer in specific district
 - ✓ **Filer does not amend a prior return**

122 Tax Court No. 8

- ◆ Plaintiffs are residents of a West coast CCRC
- ◆ Initially management used percentage method
- ◆ CCRC management changed to actuarial method
 - ✓ Plaintiffs disagreement with change
 - ✓ Plaintiffs disagreed with included costs
- ◆ Amended their tax return using
 - ✓ Financial data provided by management
 - ✓ Included costs that management did not

122 Tax Court No. 8 (continued)

- ◆ IRS area 8 office challenged return because:
 - ✓ Amended return that raised a red flag
 - ✓ Deduction amount did not jibe with information that had been prepared by CCRC management
 - ✓ Plaintiff also prepared return for several fellow residents (more than 100?)
 - ✓ Desired official guidance from national office

Trivia about 122 Tax Court No. 8

- ◆ What does “122” mean?
 - ✓ Tax court opinions are issued in “slip format”
 - ✓ Published in volumes twice a year
 - ✓ This opinion will be included in volume 122 of the US Tax Court reports
- ◆ What does “number 8” mean?
 - ✓ This will be the 8th case in volume 122
- ◆ Decision—what is the numerical deficiency?
- ◆ Opinion—statement of facts of law

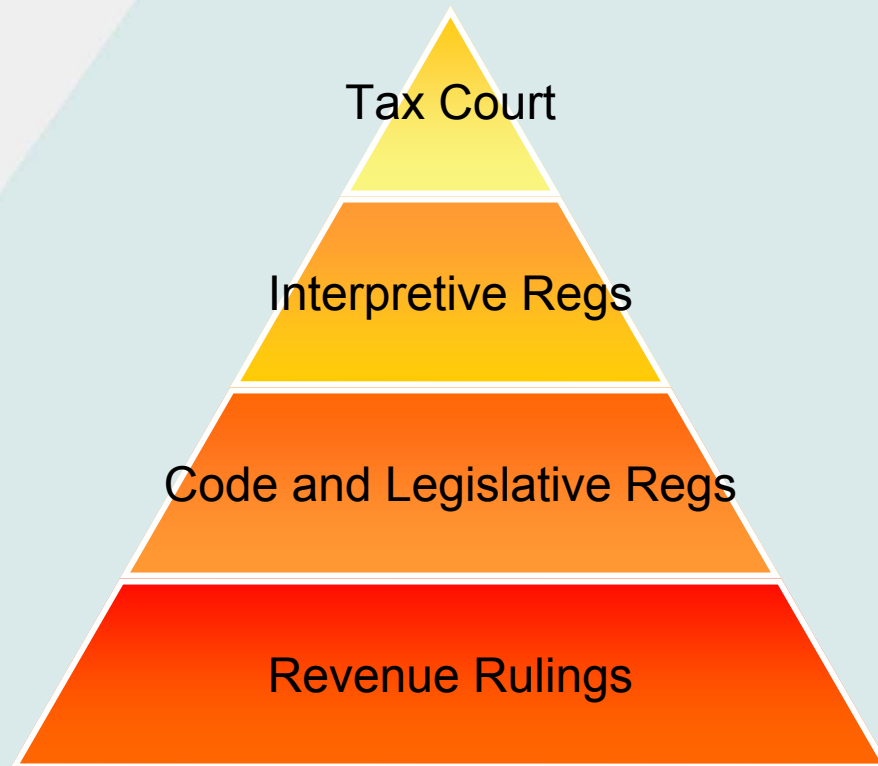
What Did the IRS Do?

- ◆ Let's find out what is "correct"
- ◆ Initial contact with AVP in January 2003
- ◆ Hired as expert witness in February
 - ✓ Literature search and advise to IRS counsel
 - ✓ Review information submitted by plaintiffs
 - ✓ Prepare report on my opinion

What Did the IRS Do? (continued)

- ◆ Expert witness report submitted August 2003
- ◆ Hearing date in September 2003
 - ✓ One-day trial
 - ✓ Direct testimony from:
 - Plaintiff—CCRC resident
 - Charlie Dalton—CFO of Air Force Village West
 - AV Powell—consulting actuary
- ◆ Tax court opinion/decision in February 2004

Hierarchy of Precedents



Expert Witness Charge

- ◆ Develop theoretically “correct” method
 - ✓ Define objective criteria
 - ✓ Identify items/amounts allocable to medical care
 - ✓ Apply to specific case
- ◆ Critique (percentage) method used by plaintiffs
 - ✓ Assess whether IRS should rely on this method
 - ✓ Advise IRS on compromise method and apply

Criteria for Appropriate Method

- ◆ Consistency
- ◆ Equal footing
- ◆ Independence
- ◆ Robustness
- ◆ Level of refinement
- ◆ Technical accuracy

Consistency

- ◆ Meaning
 - ✓ Deductible amounts for CCRCs with identical per capita medical costs should be the same
- ◆ Rationale
 - ✓ Since expected future costs are based on per capita costs, then prepayments should be equal
- ◆ Credibility of methods
 - ✓ Percentage—sometimes
 - ✓ Actuarial—always

Equal Footing

- ◆ Meaning
 - ✓ Residents with identical demographic characteristics should receive same deduction regardless of unit size or fees paid
- ◆ Rationale
 - ✓ Identical residents should have equal future expected medical care usage, therefore their prepayments should be equal
- ◆ Credibility of methods
 - ✓ Percentage—sometimes
 - ✓ Actuarial—always

Independence

- ◆ Meaning
 - ✓ Deduction should not change because group demographics change as CCRC ages-in-place
- ◆ Rationale
 - ✓ Identical residents, who move in now or ten years from now, should have equal future expected medical care usage and costs
- ◆ Credibility of methods
 - ✓ Percentage—never
 - ✓ Actuarial—always

Robustness

- ◆ Meaning
 - ✓ Method devised to calculate deduction must adjust for variations in contract provisions
- ◆ Rationale
 - ✓ Since monthly fee paid after transfer may vary by contract type, these variations should generate different prepayment amounts
- ◆ Credibility of methods
 - ✓ Percentage—never
 - ✓ Actuarial—always

Level of Refinement

- ◆ Meaning
 - ✓ Refers the extent that nuances are reflected to employ complicated formula to achieve technical accuracy versus simplification to be
- ◆ Rationale
 - ✓ Preference is a judgment call
- ◆ Credibility of methods
 - ✓ Percentage—much simpler
 - ✓ Actuarial—very complex

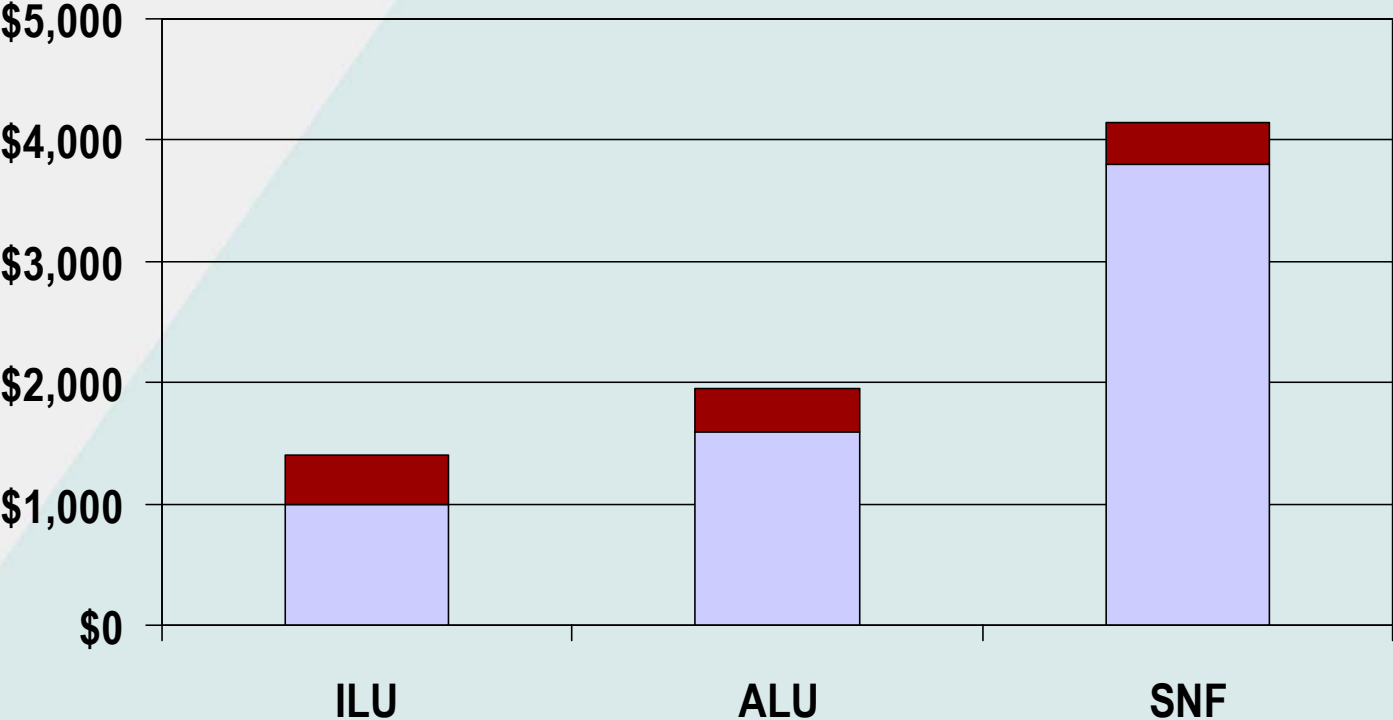
Technical Accuracy

- ◆ Meaning
 - ✓ Method should reasonably reflect the prepayment amounts based on underlying mathematics of that consider longevity and health care utilization
- ◆ Rationale
 - ✓ A logical foundation promotes fairness among particular groups of taxpayers
- ◆ Credibility of methods
 - ✓ Percentage—somewhat
 - ✓ Actuarial—always

Actuarial Theory for Calculation

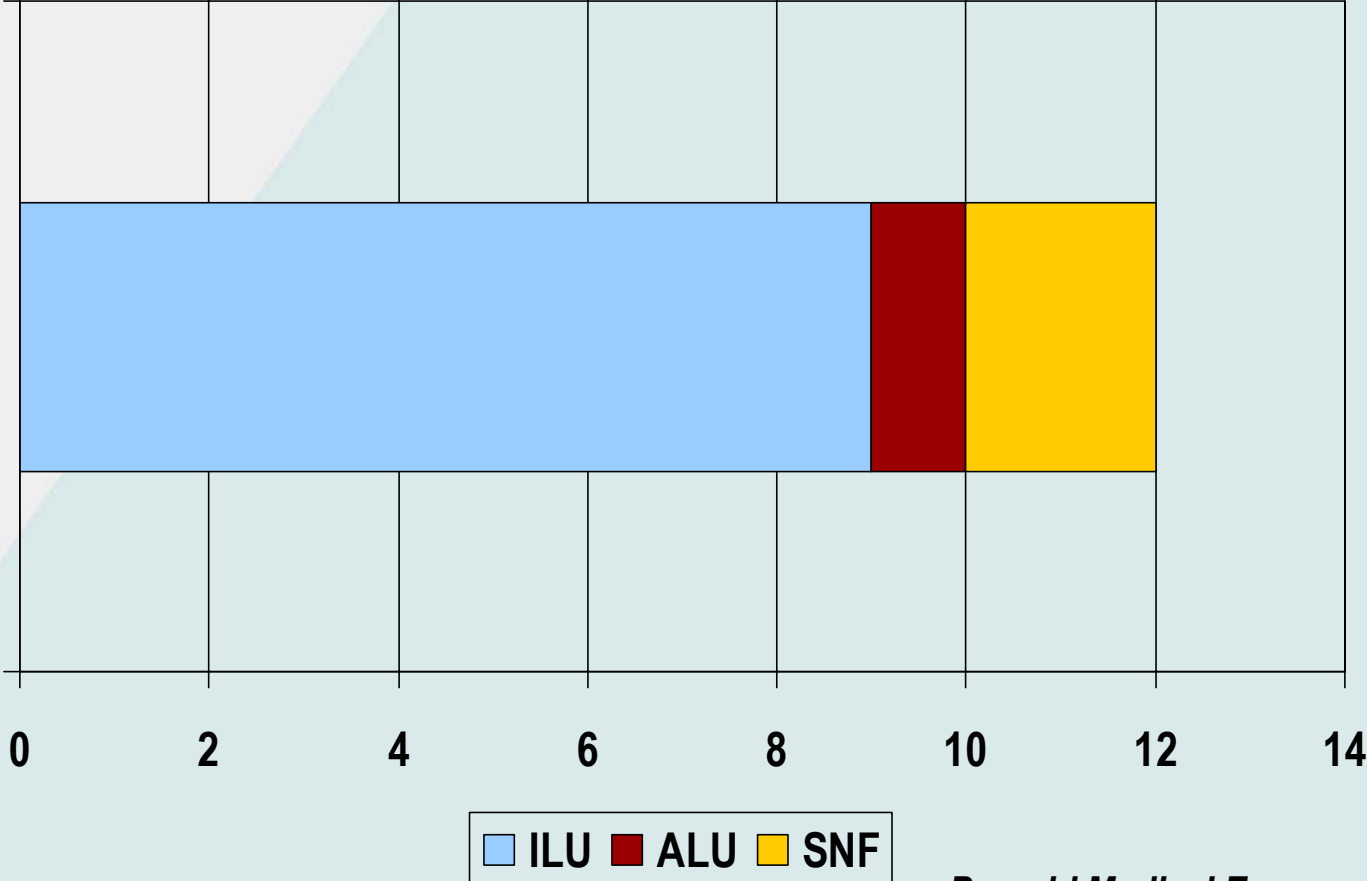
- ◆ Annual costs of services by level of care
 - ✓ Define formula(s) to spread indirect costs
 - ✓ Define allocable expense
- ◆ Longevity by level of care
- ◆ Project lifetime costs by level of care
- ◆ Project monthly fees according to contract terms
- ◆ Apply formula to calculate prepaid medical care
 - ✓ 100% of monthly deduction after transfer
 - ✓ Same monthly fee deduction after transfer

Costs of Care

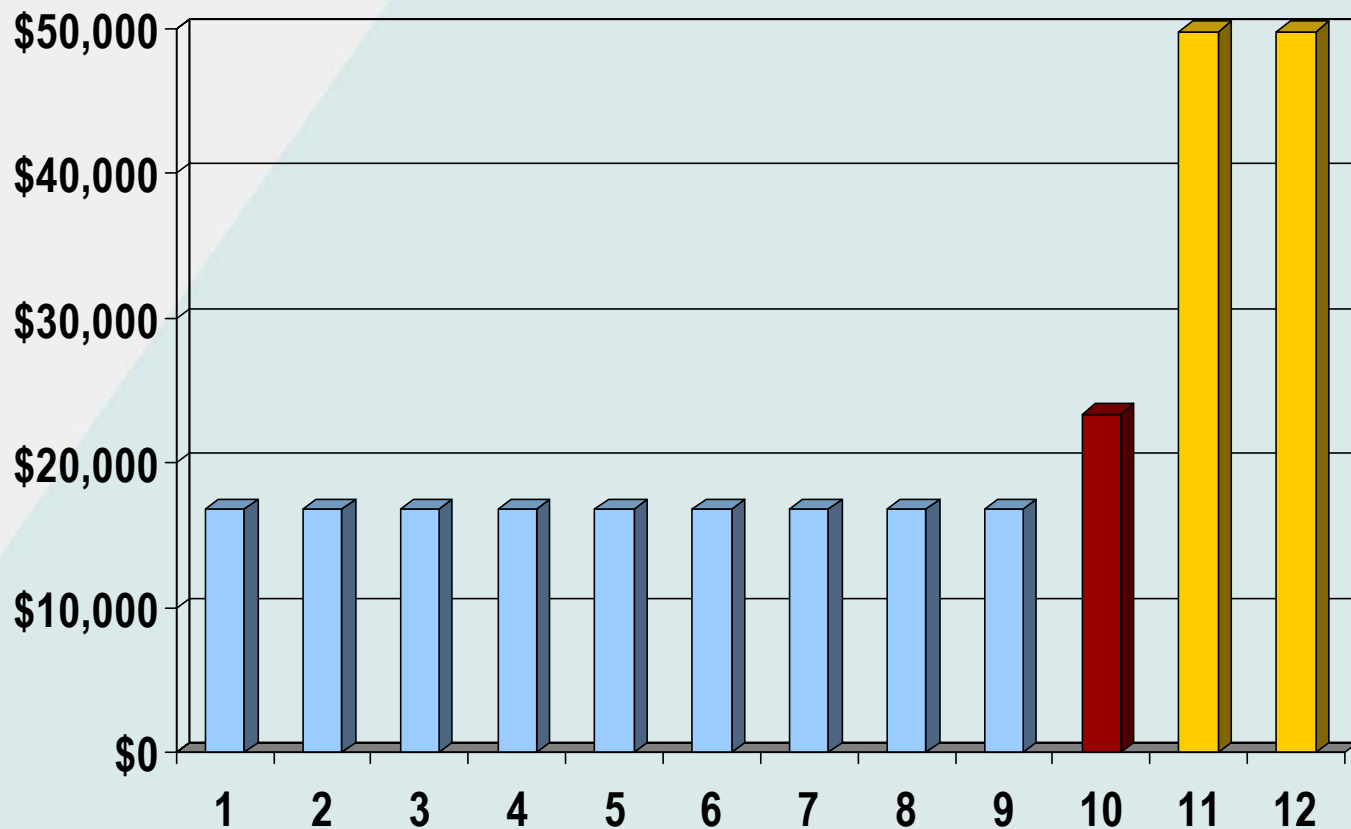


Net Operating Capital Expense

Longevity by Level of Care



Annual Costs

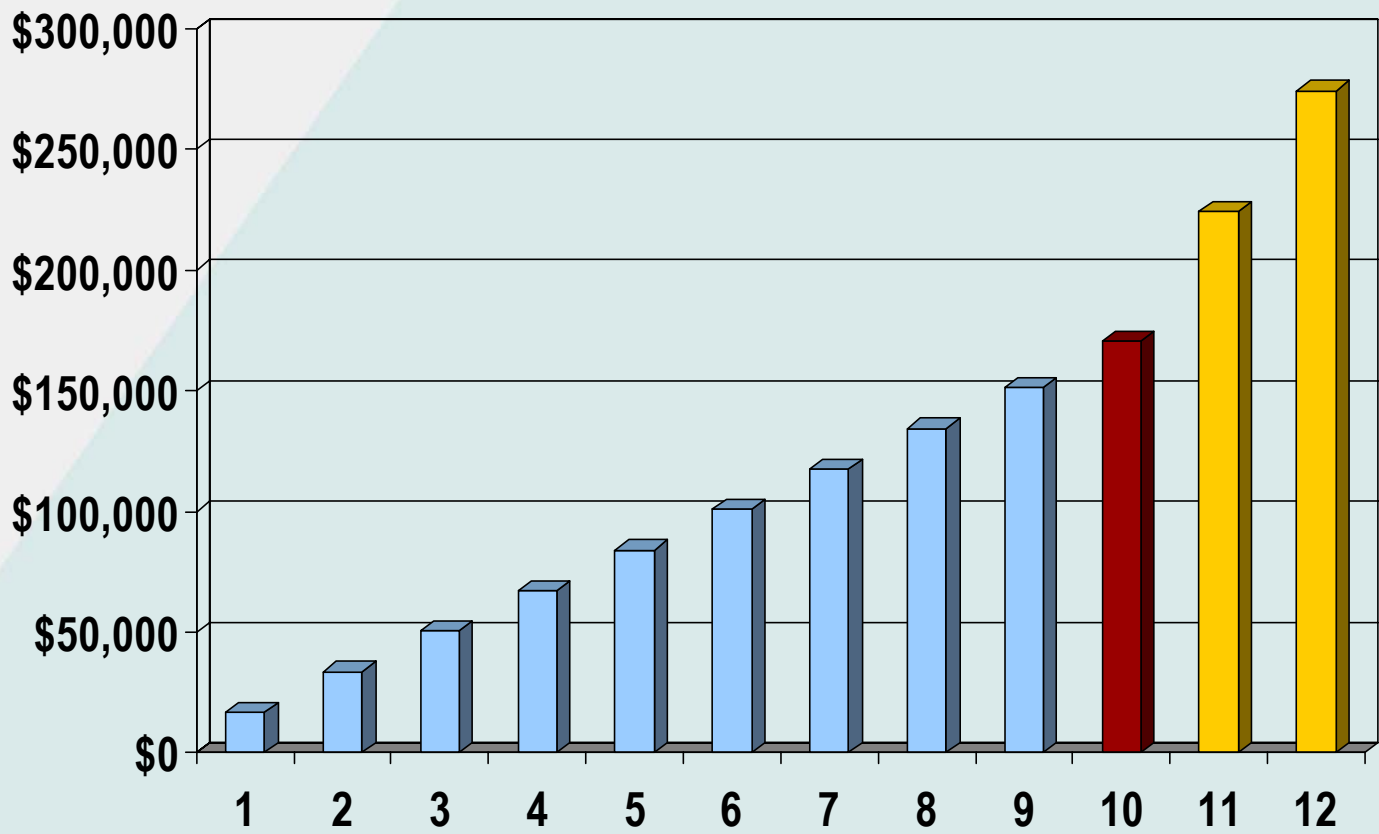


Prepaid Medical Expenses - 23

Calculate Total Costs

Total life costs	\$ 274,200
$9 \times \$ 16,800 =$	\$ 151,200
$1 \times \$ 23,400 =$	\$ 23,400
$2 \times \$ 49,800 =$	\$ 99,600

Lifetime Cost Accumulation



Prepaid Medical Expenses - 25



Equivalent Prepayment Amounts

- ◆ Claim higher monthly deduction after transfer, i.e., monthly fee that was paid before transfer
 - ✓ \$ 0 monthly fee ↔ \$ 76,200 entry fee
 - ✓ \$ 353 monthly fee ↔ \$ 38,100 entry fee
 - ✓ \$ 706 monthly fee ↔ \$ 0 entry fee
- ◆ Claim same monthly deduction after transfer
 - ✓ \$ 0 monthly fee ↔ \$ 123,200 entry fee
 - ✓ \$ 598 monthly fee ↔ \$ 36,900 entry fee
 - ✓ \$ 854 monthly fee ↔ \$ 0 entry fee

Complications and Nuances

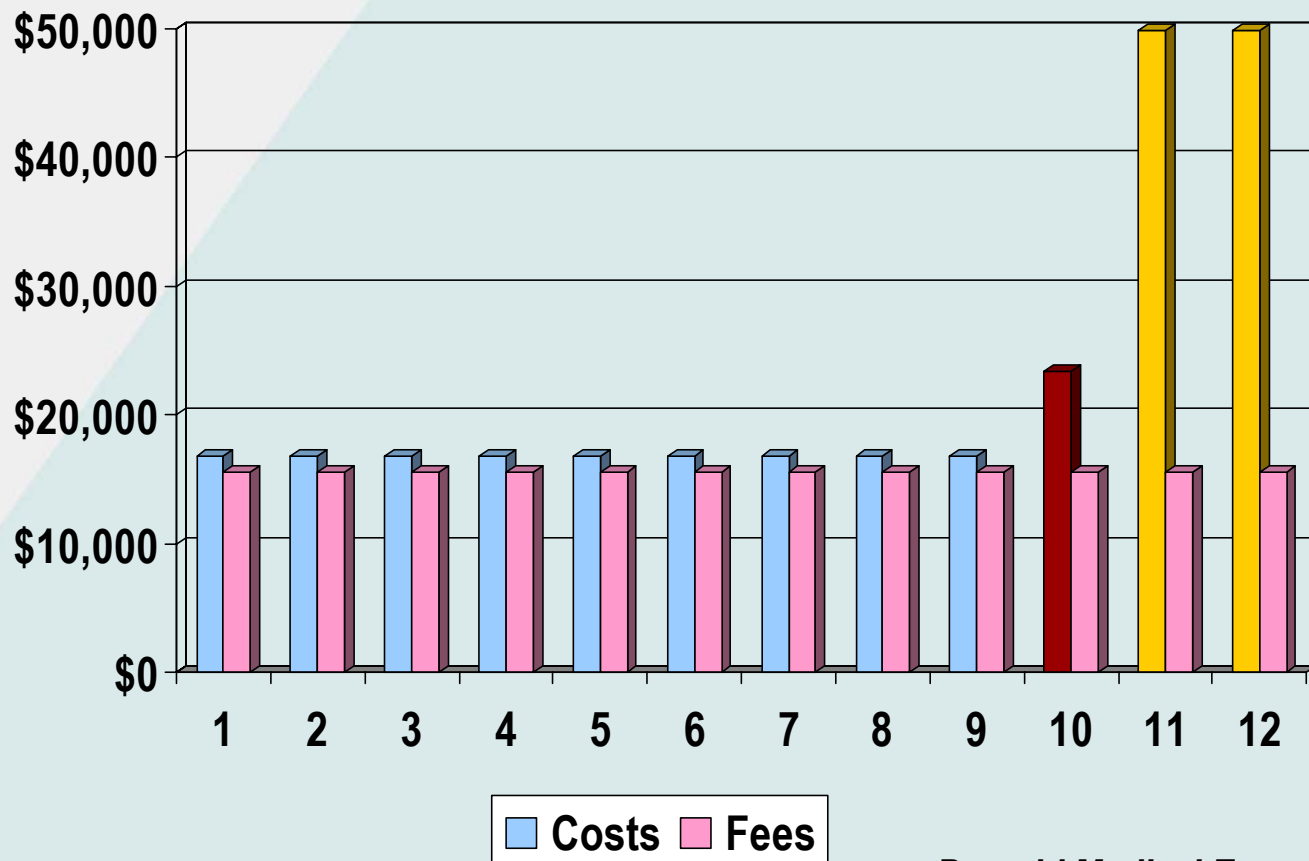
- ◆ Calculating deductions in future years
- ◆ Variations in monthly fees paid after transfer
 - ✓ Actuarial methods automatically adjust
 - ✓ Percentage methods do not adjust
- ◆ Refund provisions
- ◆ What if fees exceed costs?

Break-Even Fees

Lifetime costs	\$ 274,200
(-) entry fee	<u>(-) 87,000</u>
(=) Net costs	187,200
(÷) expected lifetime	<u>(÷) 12</u>
(=) Annual fees	\$ 15,600
(÷) 12 months/year	<u>(÷) 12</u>
(=) monthly fee	\$ 1,300



Annual Costs and Fees



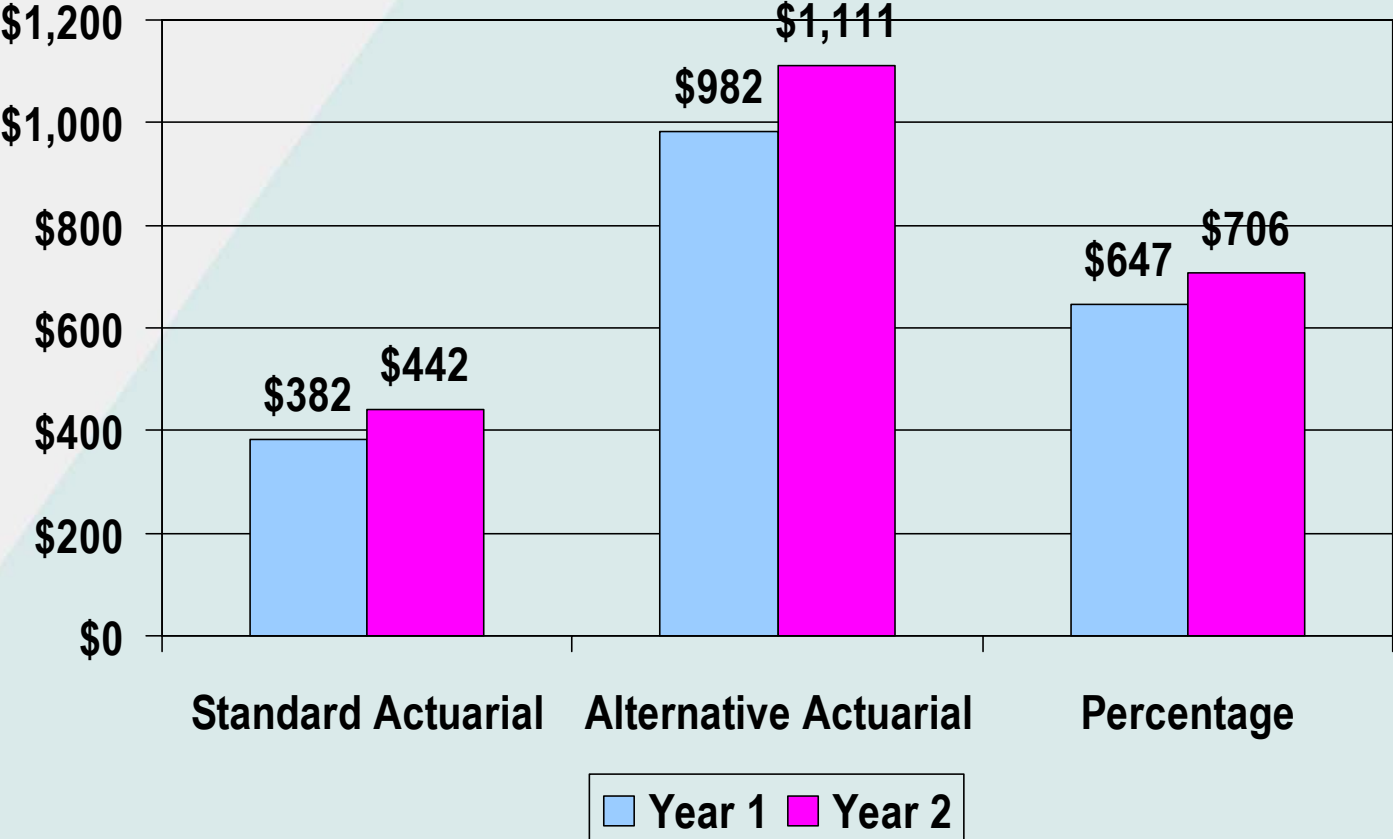
Refundable Entry Fee Deductions

- ◆ **AVP are not tax experts nor advisors**
- ◆ At least three options to limit deduction:
 - ✓ Entry fee net of gross refund amount
 - ✓ Entry fee net of actuarial present value of refunds
 - ✓ Apply full deduction in current year, and treat refund as ordinary income upon contract termination

AVP Report Summary

- ◆ Described two actuarial methods
 - ✓ Varying deduction amount (standard)
 - ✓ Constant deduction amount (alternative)
- ◆ Refined percentage method
 - ✓ Used CCRC cost allocations to levels of care
 - ✓ Included costs for assisted living and special care

Comparison of Monthly Fee Deductions



Case Study Illustration

- ◆ Plaintiffs are residents of Air Force Village West
- ◆ Philosophy pre-122 T. C. No. 8
 - ✓ Percentage method until 1997
 - ✓ Let's do it right in 1998; provide information for both percentage and actuarial
 - ✓ Resident committee disagreed with both methods

AFW Health Facility Information

- ◆ The Charlie Dalton cost center allocation method
 - ✓ Starting point for both approaches
 - ✓ Based on general reasoning if “time and motion” study has not been completed
 - ✓ Provide general guidelines for cost allocation
 - ✓ Accepted and applied by:
 - IRS expert
 - Tax Court ruling
 - ✓ Useful, and necessary for actuarial analyses

Step 1 (Health Facility Information)

- ◆ Compile interim year-end financials
 - ✓ Residents information by January 31st
 - ✓ Internal financials available in early January
- ◆ Objective:
 - ✓ Initially calculated numerator and denominator for health care percentage
 - ✓ Currently provide information for residents to make their own calculations

Step 2 (Health Facility Information)

- ◆ Allocate expenses to cost centers by applying “rules” as defined in Step 3
- ◆ Develop cost center reports
 - ✓ Assisted Living Units
 - ✓ Special care unit
 - ✓ Skilled nursing care
 - ✓ Residential Living Units (by subtraction)

Step 3 (Health Facility Information)

- ◆ Allocation similar to Medicare cost report
- ◆ Each expense line item has an allocation rule

Summary of Allocation Rules

Food service	Percent of total contract
Payroll and benefits	Direct labor plus benefits
Departmental costs	According to department, except payroll and benefits
Housekeeping/laundry	Percent of total contract
Maintenance	Specific dedicated staff
Landscape	Previous time study

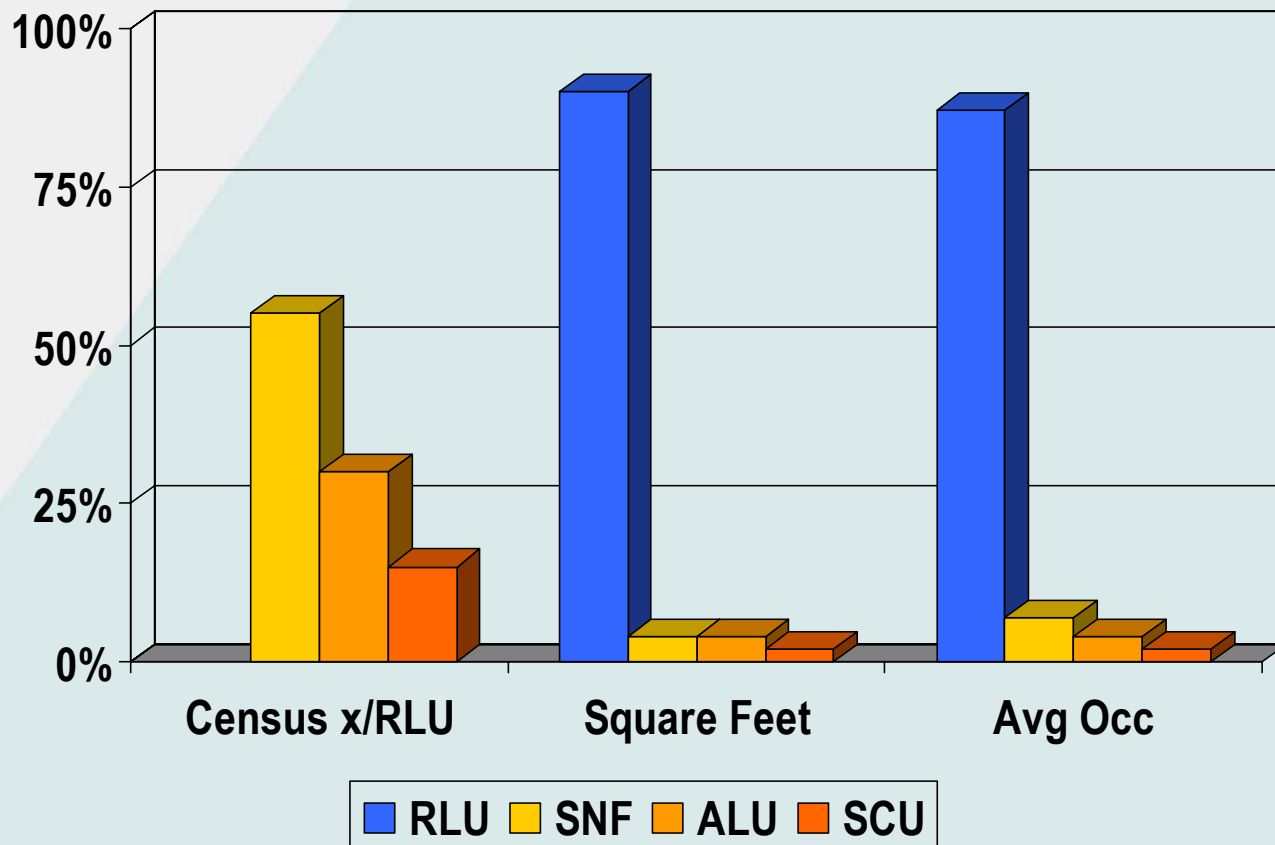
Summary of Allocation Rules (cont.)

Administration	Previous time study
Insurance	Special census and square feet allocation rules
Linens	Direct purchase for SNF
Depreciation and amortization	Fixed asset program
Contracts	Alarm system, copiers, fire drill, medical director, and so forth
Utilities	Square feet

Example #1 detail of allocation rules

- ◆ Insurance and utility expenses
 - ✓ Direct insurance based on health center census
 - Under new carrier professional liability covers entire census so allocated as such
 - ✓ Commercial packages and earthquake insurance based on entire facility's square feet
 - ✓ Comprehensive crime, notary, and D&O insurance based on entire census
 - ✓ Utilities based on entire facility's square feet

Allocation Factors



Example #2 detail of allocation rules

- ◆ Contracted services
 - ✓ Such as dining and housekeeping
 - ✓ Allocation percentages provided by contractor
 - ✓ 23-to-27% allocated to health center

Example #3 detail of allocation rules

- ◆ Pull cord system
 - ✓ Monitors RLU
 - ✓ Staffed by Resident Services and Security
 - ✓ Cost formula uses
 - Average hourly rate
 - Overhead factor

Change in procedure in post-1997

- ◆ Pre-1997
 - ✓ AFVW completed following steps 4 and 5
- ◆ Post-1998
 - ✓ Provide health care information
 - ✓ Weighted average fees
 - ✓ Medicare & HMO payments
 - actual cash payments
 - do not tie to financials since done on accrual basis

Step 4 (Health Facility Information)

- ◆ Deduct specific revenues from numerator
 - ✓ Private pay
 - ✓ Medicare and HMO payments
 - ✓ Other

Step 5 (Health Facility Information)

- ◆ Calculate medical care amount
 - ✓ \$6.4 million in health care expenses
 - ✓ \$1.7 million in non-resident health care revenues
 - ✓ \$20.3 million total expenses
 - ✓ ~25% health care
 - \$4.7 million numerator
 - \$18.6 million denominator
- ◆ Apply to fees (use weighted average after 2003)

AFVW Current Procedures

- ◆ Philosophy post-122 T. C. No. 8
 - ✓ Provide information for both approaches
 - ✓ Provided weighted average fees for use Tax Court's opinion on how to apply percentage

Prepaid medical anecdotes

- ◆ Additional single-purpose staff efforts
- ◆ Drop dead date of January 31st
- ◆ Communications with residents' accountants
- ◆ Resident committees' and individual comparisons

Conclusions

- ◆ What does the tax ruling say?
- ◆ What doesn't the tax ruling say?
- ◆ Unresolved or non-addressed issues

Tax Court Findings

- ◆ Plaintiffs not required to use actuarial method
- ◆ Certain costs not allocable as medical care
 - ✓ Pool
 - ✓ Spa
 - ✓ Exercise facilities
- ◆ Suggests deduction should be same amount for all unit types regardless of monthly fee paid
- ◆ AVP government-certified “actuarial” expert 😊

Limitations of Tax Court Ruling

- ◆ No precedent for entry fees since no part of case
- ◆ Did not preclude use of actuarial approach
 - ✓ IRS counsel felt actuarial method appropriate
 - ✓ Court believe too complicated
- ◆ Did not address “double dipping” potential
 - ✓ Percentage should apply for lifetime
 - ✓ AVP believes that residents will claim 100% of fees after transfer to medical facilities

Implications (AVP interpretation)

- ◆ Portion of monthly and entry fees are deductible
 - ✓ Okay to use reasonable cost of care allocations
 - ✓ Percentage method okay if prior history
 - ✓ Be careful if vary by unit type
- ◆ “Definition” for percentage calculation
- ◆ Safe harbor using actuarial method
- ◆ Potential loophole for fee-for-service contracts

What's "Right" versus What's Legal

- ◆ What if fees are not set to follow the actuarial cost implications?
- ◆ Example—no second person entry fee
 - ✓ If apply percentage method, singles and couples get same deduction
 - ✓ If apply actuarial method, couple's "net entry fee" is less than single's

What Should You Do as CFO?

- ◆ Provide information, not recommendations
- ◆ If use percentage, move to weighted fee average calculation so all residents have one amount
- ◆ Change to actuarial method?
 - ✓ Maybe; percentage method is acceptable for now
 - ✓ But how do you determine entry fee amount?
- ◆ Provide information for resident to calculate percentage method if organization uses actuarial