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Financing Assisted Living With Low-Income Housing Credits

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Developing affordable housing for the elderly which provides the least restrictive environment possible is a challenge. Many elderly people do not need the expensive full-time care that a traditional nursing home provides. However, often low-income elderly people who could live independently with moderate personal care assistance end up in nursing homes because there is no viable alternative or because subsidies are available only in conjunction with nursing home occupancy.

Assisted living is a growing field which provides one popular alternative to nursing home care, blending residential and personal services. Assisted living residences usually provide, in exchange for a standard monthly payment, basic residential services, such as laundry, light housekeeping, and one meal a day, in addition to maintenance of a resident's living quarters. Residents choose (and pay for) additional services they need, ranging from assistance with dressing, bathing, medication, and doing errands to transportation services, private companions, guest meals, physical therapy, and medical services.

To date, most assisted living facilities have not served the low-income elderly, but rather have targeted a population that can pay for both the rent and personal care services provided. However, there is a great need for such housing for low-income elderly, particularly in light of the increasing elderly population in the United States.

Some developers of assisted living facilities have begun utilizing the federal low-income housing tax credit to create affordable housing for the low-income frail elderly. At least one state housing agency, the Massachu-

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setts Housing Finance Agency (MHFA), has an Elder Choice program which provides construction and permanent financing for the development of assisted living facilities in which at least 20 percent of the units are rented to low-income tenants. The first such Massachusetts tax credit project broke ground in 1995 in the Boston area, combining housing tax credits, HOME funds, MHFA funding, and other public and private debt. Several additional projects have since been completed or are in the pipeline.

An increasing number of developers have utilized tax-exempt bonds to finance assisted living projects. A mid-1997 private letter ruling by the Internal Revenue Service, however, has caused problems in some states in trying to get legal opinions necessary to obtain tax-exempt financing, and the housing tax credits available for a bond-financed project. *(See story on p. 8.)*

Special Issues Involved

As the market for assisted living facilities expands, some special issues under the housing tax credit rules resulting from the combination of housing and services offered are being worked through. For example, housing credits are only available for residential rental projects.

The credit is not available for any unit that is part of a transient facility, such as a hospital, nursing home, sanitarium, life care facility, trailer park, or intermediate-care facility for the medically or physically handicapped. Accordingly, care must be taken that the level of medical services provided does not transform the project into one that is beyond the definitional confines of residential real estate. Residents should be free to, and must have the obligation to, secure their own medical care providers. Also, each living unit should have a lockable door, be separate and distinct from the other living units, and have a separate kitchen and bathroom. Leases should be for a minimum of six months.

Medical, Health Issues

The tenant selection process is particularly sensitive, to ensure that such tenants are sufficiently healthy to live independently with limited assistance in the activities of daily living. Some state statutes regulating assisted living facilities help in this regard by imposing limitations on the amount of nursing care for residents of assisted living facilities.

For example, in Ohio, an assisted living residence may not admit individuals who require 24-hour skilled nursing care and may not provide such care "for a period longer than reasonably necessary to complete an appropriate transfer of the person." In Alaska, residents may not receive more than 45 days of 24-hour skilled nursing care.

In contrast, under the Massachusetts statute, assisted living residences may not admit individuals who require 24-hour skilled nursing care and may provide such skilled care only for a period of under 90 days, for short-term illnesses, and if provided by staff unaffiliated with the residence. However, the housing tax credit rules generally are more restrictive than a given state's regulatory scheme (if one exists); consequently, one cannot assume that the residential rental character of a facility is retained even if the facility complies with state regulations.

Rent Rules, Services

Another critical tax issue in structuring assisted living projects so they comply with the housing tax credit rules is the necessity of complying with the rent restriction rules. A qualified low-income project must restrict rent in low-income units to 30 percent of 50 percent of area median income (or 30 percent of 60 percent of median income if the 60 percent set-aside test is used). Under U.S. Treasury regulations "rent" includes charges for services that are "not optional," and the cost of services that are "required as a condition of occupancy" must be included in the gross rent calculation.

Therefore, if a facility requires residents to pay for services, rent, and food in a combined mandatory package, and if the cost exceeds the rent limitation (as would almost certainly be the case), the facility would not be eligible for housing tax credits. Consequently, residents must generally be free to reject services provided by the facility and to purchase the same services from one or more alternative service providers.

The determination of whether a service is considered optional is a fact-specific determination that may depend on factors such as a facility's day-to-day operation and its fee structure. Treasury regulations provide that if continual or frequent nursing, medical, or psychiatric services are provided it is presumed that the services are not optional and that the building is ineligible for the credit. The regulations also state that meals provided in a common dining facility are considered optional only if payment for the meals is not a condition of occupancy and a practical alternative exists for tenants to obtain meals. The determination of whether meals are truly optional, therefore, could vary for two facilities similarly organized, based perhaps on the design of cooking space in the units, accessibility to supermarkets, and other

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project-specific factors.

Certain Subsidies Special

Certain subsidies, however, are not treated as rent under the housing tax credit rules. For example, rent does not include certain subsidies paid to the owner of the project by any governmental program of assistance (or a tax-exempt organization) for a supportive service that is designed to enable the resident to remain independent and avoid placement in a nursing home or hospital. The subsidy must provide assistance for rent and the amount of assistance for rent must not be "separable" from the amount of assistance provided for supportive services. Therefore, if a subsidy fits under this definition there is no requirement that its payment be optional and it will not be counted against the rent limitations of Section 42 of the Internal Revenue Code. Consequently, the determination of how to structure mandatory or optional payments for rent and services may vary depending on the source of the payments.

There is very little authority interpreting this exception. The Internal Revenue Service in 1995 issued a private letter ruling (9526009) to the effect that supplemental payments made by a state under its SSI (Supplemental Security Income) program directly to qualifying individuals for the purpose of allowing low-income elderly to live in assisted living facilities could be excluded from the calculation of rent under Section 42. Accordingly, the project could charge residents a single non-separable fee for rent, board, transportation, housekeeping, social services, and other supportive services. This ruling represents a broad view of the exception since the statute requires that payments be made by a governmental entity to the project owner, not directly to the recipients. Hopefully this is an indication that the Internal Revenue Service will take a broad view of the statute in the assisted living area, but in general there is still very little guidance, and many issues will need to be addressed and resolved as housing tax credits are more widely used for assisted living.

Compliance Issues

It should also be noted that compliance issues with a low-income elderly population may differ from the general low-income population. Elderly persons may have little or no earned income, but may have accumulated significant assets over their lifetimes (such as on the sale of their houses, family heirlooms, etc.). Accordingly, great care must be taken to ascertain a person's investment income to ensure that an individual qualifies as a low-income tenant. In this regard, if a family has assets in excess of $5,000, income will include the greater of the actual return on such assets or an imputed amount based on the passbook savings rate as determined by the U.S. Department of Housing and Urban Development. In general, however, low-income elderly may be a very stable and low-risk rental group because their Social Security income and accumulated assets are not as subject to general economic downturns as might be the case with tenants relying on earned income.

It is likely that the use of housing tax credits to raise equity in assisted living projects will increase. However, structuring and developing assisted living facilities challenges developers and consultants because of the mix of housing, tax, and health care issues. Partnerships between housing developers, nonprofits, and persons experienced in the care of the elderly (for example, nursing home operators) are becoming more common. It is an exciting process to draw together persons from various fields to try to fulfill a pressing need of providing quality low-income housing for qualified elderly persons.❐

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IRS Private Letter Ruling Causes Some Confusion About Use of Credits and Bonds for Assisted Living

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The use of low-income housing tax credits and tax-exempt financing to develop assisted living facilities that are affordable to low-income seniors has been negatively impacted in some parts of the country by an unfortunate series of events. These include a private letter ruling (9740007) issued by the Internal Revenue Service (IRS), and the reactions to it by some in the legal community. *(For broader article on assisted living facilities and housing credits, see story on p. 1.)*

Private Letter Ruling 9740007 (6/27/97) concluded, based on some unique factual circumstances (and, in our view, a mistaken interpretation of current law), that an assisted living facility did not constitute "residential rental property," a necessary condition to obtain low-income tax credits and tax-exempt private activity bond financing.

Because of PLR 9740007, some bond counsel have grown reluctant to issue the tax opinions necessary to facilitate issuances of tax-exempt bonds. Accordingly,

assisted living projects in several states, including New York and New Jersey, have been slowed because of the confusion over the status of assisted living as "residential rental property."

Qualification as Residential Rental Property

Both housing tax credit projects and assisted living projects [owned by entities which are not exempt organizations as defined in Section 501(c)(3) of the Internal Revenue Code] which utilize tax-exempt bond financing must qualify as residential rental property.

A "qualified residential rental project" is defined in Section 142(d) of the Internal Revenue Code with respect to tax-exempt bonds and a "qualified low-income housing project" is defined in Section 42(g) of the Internal Revenue Code with respect to the low-income housing tax credit. Under both sections, a qualified project must be residential rental property, in addition to meeting certain other tests, such as income and rent restrictions under Section 42(g) and income restrictions under Section 142(d).

Two-Prong Residential Rental Test

The Internal Revenue Code, legislative history, and U.S. Treasury regulations have consistently defined a residential rental project as consisting of:

> (1) A building in which each unit includes separate and complete facilities for living, sleeping, eating, cooking and sanitation; and,
>
> (2) Housing units which must be used on other than a transient basis, thus excluding motels, dormitories, hospitals, nursing homes, retirement homes, and trailer parks (which are considered transient) from qualifying as residential rental property.

The legislative history and regulations do not impose a requirement that the provision of services, even substantial services, prevent a project from qualifying as residential rental property or that the provision of services is relevant to this determination. In fact, the legislative history to the 1998 tax act, in the explanation of an amendment to the tax-exempt bond requirements, stated that even a continuing care facility (typically involving frequent and extensive services) could qualify as residential rental property. In addition, regulations for the housing tax credit provide that the furnishing of significant services to residents does not prevent units from qualifying as residential rental property eligible for the credit. Thus, the focus has continually been on whether the units meet the two-pronged basic definition described above.

Accordingly, prior to the issuance of PLR 9740007, assisted living facilities utilizing housing tax credits and tax-exempt bond financing were widely recognized as passing the residential rental test without regard to the specific assisted living statute in each state (provided the above tests were satisfied). For example, in a 1997 private letter ruling (9711021), the IRS stated that an elderly housing project could qualify as a residential rental project eligible for tax-exempt financing, if the kitchen cooking facilities only included a microwave oven (instead of a traditional cooking range) for safety reasons in cases where the resident had physical or mental frailties. The IRS made no mention of the level of services provided in the facility, rather, the inquiry in the ruling was whether the traditional criteria of a residential rental project were met. *(For details about the letter ruling, see The Tax Credit Advisor, April 1997, p. 15.)*

Background on Recent Letter Ruling

PLR 9740007 involved a highly state-regulated assisted living project (in an unidentified state). The ruling concluded that a relevant inquiry is whether the facility is involved in "providing residences for individuals as compared to bed space in a health care facility."

The fact-specific ruling, at best, stretched the law to help a specific taxpayer. The taxpayer had wanted the assisted living facility to be classified as a health care facility rather than as residential rental property in order to qualify for tax-exempt financing provided by Section 501(c)(3) bonds, which are different from tax-exempt private activity bonds. The facility in question would not have qualified for Section 501(c)(3) bond financing if it were classified as a residential rental project.

In finding the project to be a "health care facility," the ruling found relevant that: (i) the facility was regulated by the state health department; (ii) it accentuated the availability of immediate medical service and/or the care of the persons being serviced; (iii) the laws of the state and/or the regulations and rules of that state's health department specify numerous procedures, measures and standards pertaining to both the medical treatment of residents and the level of necessary staffing; and (iv) the relationship went far beyond a landlord-tenant relationship.

These factors are already at one end of the spectrum of state requirements for assisted living, with many states taking a less health-care oriented approach. That is, these states don't tend as much to require certain health care services to be provided in order to be certified, but rather tend to stress the provision of personal care services. In addition, the ruling stated facts which are not present in most assisted living facilities, including: (i) husbands and wives could not share a unit unless both qualified for the

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facility; (ii) no family members were allowed to reside temporarily or even for overnight visits in a unit; and (iii) other visitation rights were limited.

Implications of Letter Ruling

This ruling is not considered legal precedent for other cases. An IRS private letter ruling may only be used by the taxpayer to which it is issued; it may not be used as precedent by others.

PLR 9740007 does not appear to represent an attempt by the IRS to set new standards or policy for assisted living (which view has been unofficially confirmed in a meeting which one of the authors attended with representatives of the Treasury Department). Instead it was a fact-specific ruling.

Generally, assisted living facilities should pass the "residential rental project" test if each unit is a complete living unit and leases are at least six months long. There is nothing inherently transient about assisted living, provided that a facility does not admit individuals requiring continual or frequent nursing, medical, or psychiatric services as would be the case in a nursing home or hospital. Since assisted living facilities generally provide personal care services and other non-medical services and little or no actual medical services, such facilities should not be treated as being used on a transient basis merely because of the level of non-medical services provided. Being elderly does not, in and of itself, mean occupancy is transient.

Bond Community Focus Is Changed

Nonetheless, the focus of the bond community has shifted. Some projects have come to a halt in states which regulate assisted living in more of a medical model and which provide for regulation of assisted living facilities by the state's health department and may impose greater duties to provide medical personnel and services. This appears to be true even if the state statute prohibits the admittance of persons requiring skilled nursing or medical care. In other states, such as Massachusetts, which have assisted living statutes following a residential model, projects have continued to move forward, with the requisite bond and housing tax credit opinions.

In addition, even in states where regulation of assisted living projects follows a medical model, certain projects [those not owned by a Section 501(c)(3) organization] may have sufficiently distinguishable factual circumstances from PLR 9740007 to enable counsel to render the necessary bond and housing tax credit opinions based upon the project qualifying as residential rental real estate.

This disparity is unfortunate because similar projects in different states receive different treatment. So long as the facility is not transient, contains complete units, and persons requiring extensive medical care are not admitted (i.e., medical services are not so frequent and continual to raise to the level of a nursing home), a project should be considered a residential rental project.

Further Clarification Required

It should be noted that the IRS has announced that this is an area requiring further clarification in response to the protest of the tax-exempt bond and tax credit community to resolve this issue and the apparent inconsistency between PLR 9740007 on the one hand and PLR 9711021 (the microwave ruling) and the legislative history discussed above. Hopefully, this issue will be resolved favorably and promptly to enable developers to provide affordable assisted projects for deserving elderly persons under consistent rules, without regard to the state in which such facility is located.□

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