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ATB clarifies "entry fee communities" tax method

By Jeffrey Sacks

The Massachusetts Appellate Tax Board (ATB) has recently reaffirmed the use of the income-capitalization method for the real estate taxation valuation of senior living facilities that use an entry fee model.[1] While clarification of the appropriate real estate tax valuation methodology should lead to fewer disputes between real estate owners and tax assessors, the methodology approved by the ATB for these types of facilities has a feature which, in a volatile interest rate climate, could lead to substantially higher tax bills.

Entry fee communities: what they are and how they're taxed

Entry fee communities are a unique form of senior housing development, which usually offer residents housing and services at the level of support required for their individual needs. Often these communities are a mix of independent living units (ILU's), assisted living units (ALU's), and adjacent skilled nursing home (SNF) facilities. What makes these arrangements unique is the payment model for living in the community. Residents will typically pay a large upfront "entrance fee" which is partially refundable upon the end of their residency. These "entrance fees" are quite large and can range anywhere from $100,000 to over $1,000,000. Residents also pay monthly occupancy payments.

For real estate taxation purposes, when calculating the fair market value of the property, it can be difficult to categorize and account for these entrance fees. At first glance, they may appear to be like rental deposits. However, this large sum is not typically placed into a deposit account earning interest like a security deposit, but rather is used by owners of these facilities to pay off the construction debt taken out to build the communities and then is used to pay the refundable portion of the entry fees as units turn over.

Entry fee communities in the courts

Although these funds are not held and invested by the facility owner, in 2002 the ATB determined that potential earnings on these fees should be treated as a source of income for the projects.[2] In order to account for this hypothetical income, the ATB determined that these hypothetical

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[1] *Village at Duxbury v. Board of Assessors*, F325880 (Jun. 19, 2019 Appellate Tax Board).

[2] *Willows at Westborough v. Board of Assessors*, F252006, 2002 WL 31319512 (Oct 16, 2002 Appellate Tax Board).

earnings, or "imputed income," should be added to the actual income of the development when using the income-capitalization method to calculate the valuation of the facility for property tax purposes.[3] The Massachusetts Appeals Court agreed with the ATB finding that, "the fact that the [facility] has chosen to use the money collected as entrance fees to pay down construction costs . . . rather than place it in an interest-bearing account of some sort does not change the fact that this money is a form of income. . . ."[4] In order to capture these fees as part of the income derived by the property, the amount of the paid entry fees was assigned an interest rate to determine the amount of imputed income.[5] In the 2002 case, the ATB did not specify how to calculate this interest rate, merely stating that "the income attributable to [the refundable fee] in any year is the amount of interest that *reasonably and safely* could be earned. . . during the fiscal year."[6] (emphasis added). One of the experts that were quoted in the ATB opinion had reviewed United State Treasury note rates to determine an appropriate interest rate.[7]

This past June, the ATB was again confronted with how to properly account for similar fees.[8] Like in the 2002 case, the ATB affirmed the use of an income-capitalization method, including the imputed income on the amount of the refundable entry fees. In this case, the ATB affirmed an appraiser's method which explicitly used the seven and ten-year T-note as of the taxing date as a basis for determining a "safe and reasonable" interest rate.[9]

The use of the T-note interest rate to determine the "imputed income" of an entry fee facility exposes these facilities to dramatic increases in real estate taxation if interest rates increase. Higher rates on the seven and ten-year T-notes would mean a higher valuation of the property and a larger real estate tax bill. As shown in Table 1, an increase in the T-note interest of 1% could increase a property's tax bill by almost 30%. The difference in rates from 2018 (2.42%) to that of 2002 (5.09%) would equate to a difference of 45% in the real estate taxes due. The basis for this significant increase in real estate taxes is not tied to the performance of the facility, but rather the imputed interest earnings on the refundable entrance fees which most facilities have not invested but rather have used to pay off their construction debt.

Effects of Imputed Interest on Real Estate Tax Bills

Imputed Interest Rate	***Indicated Value for Facility****	***Real Estate Tax Due***
2.42% (2018 average of 7 & 10-year T-note rate)	$28,114,270	$360,144
3.50%	$33,305,865	$426,648
4.50%	$38,112,897	$488,226
5.09% (2002 average of 7 & 10-year T-note rate)	$40,949,046	$524,557

**Assuming 100-unit facility with $1,200,000 in annual adjusted net income and $35,000,000 in total entrance fees.*

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[3] Id.

[4] *Willows at Westborough v. Board of Assessors*, 60 804 N.E.2d 963 (Mass App. Ct 2004).

[5] *Willows at Westborough v. Board of Assessors*, F252006, 2002 WL 31319512.

[6] Id.

[7] Id.

[8] *Village at Duxbury v. Board of Assessors*, F325880.

[9] Id.

What's next?

As we enter a time with volatile interest rates, continued use of this income-capitalization method that includes imputed interest income from the refundable portion of entrance fees will lead to greater variability in real estate tax bills for these facilities and significantly higher real estate taxes if interest rates increase. Facilities must be aware of this issue in the coming years in order to properly plan for these potentially higher costs. Alternatively, facilities could consider challenging the status quo and arguing for the use of a different approach, such as the comparable sales method, in valuing these facilities for real estate tax purposes. In any case, when preparing annual budgets, careful attention must be given to seven and ten-year rates in modeling the amount of projected real estate taxes for the next fiscal year.

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