**Office of Chief Counsel**
**Internal Revenue Service**
# memorandum

Number: **201049026**
Release Date: 12/10/2010

CC:ITA:B07:BPHarvey
POSTN-126540-10

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 168.20-00

date: September 23, 2010

to: Associate Area Counsel - Seattle
(Small Business/Self-Employed)
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from: Branch Chief, Branch 7
subject: (Income Tax & Accounting)

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Adult Home Care Business as Residential Real Property
POSTN-126540-10

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

Whether a house used to operate an adult home care business that cares full-time for adults who cannot live on their own qualifies as residential rental property for purposes of § 168(e)(2) of the Internal Revenue Code such that the owners of the house are entitled to depreciate the house using a 27.5 year recovery period, under the general depreciation system of § 168(a).

CONCLUSIONS

The house qualifies as residential rental property for purposes of § 168(e)(2). Thus, the owners should determine depreciation for the portion of the house leased as dwelling units by customers of the adult home care business (but not the portion of the house that is owner-occupied) using a 27.5 year recovery period (or a 40 year recovery period if the alternative depreciation system of § 168(g) applies).

FACTS

Taxpayers own, and have operated out of their house, an adult home care business since 2005. They provide general care for adults who cannot live on their own

("residents"). The residents live full-time in the taxpayers' house. On average, the taxpayers have three to four residents living with them at any time. The majority of residents stay in the house on a non-transient basis. The taxpayers provide 24 hour supervision and care for the residents, laundry service, maid service, upkeep of the house, landscaping, transportation, and other services. The residents each pay $3,000.00 per month to the taxpayers. Approximately $1,000.00 of this amount is allocated by the taxpayers to the rent of a bedroom and the right to use the bathroom, kitchen, and living room. Approximately $2,000.00 is allocated to the services that the taxpayers provide for their residents.

The taxpayers allege that their house qualifies as residential rental property under § 168(e)(2) and have depreciated the house using the 27.5-year recovery period. Upon examination, the Internal Revenue Service determined that the taxpayers' house did not qualify as residential rental property and that the taxpayers were required to depreciate the house using the 39-year recovery period for nonresidential real property.

LAW AND ANALYSIS

Section 167(a) generally allows as a depreciation deduction a reasonable allowance for the exhaustion, wear, tear, and obsolescence of property used in a trade or business. Section 168(a) provides that the depreciation deduction provided by § 167(a) for any tangible property placed in service after 1986 must be determined using the applicable depreciation method, the applicable recovery period, and the applicable convention. Only the applicable recovery period is at issue in this case. Section 168(c) assigns recovery periods of 27.5 years and 39 years to residential rental property and nonresidential real property, respectively, for purposes of the general depreciation system of § 168(a).

Under § 168, the applicable recovery period is determined by the property's classification under § 168(e). In general, § 168(e) classifies real property as either residential rental property or nonresidential real property. Section 168(e)(2)(B) defines nonresidential real property as § 1250 property that is not residential rental property or property with a class life of less than 27.5 years.

Section 168(e)(2)(A)(i) defines residential rental property as any building or structure if 80 percent or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units. If any portion of the building or structure is occupied by the taxpayer, the gross rental income from the building or structure includes the rental value of the portion occupied by the taxpayer. Section 168(e)(2)(A)(ii)(II).

Section 168(e)(2)(A)(ii)(I) provides that a dwelling unit means a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, or other establishment more than half of the units in which are used on a transient basis.

Prior to the enactment of the Omnibus Budget Reconciliation Act of 1990, § 168(e)(2)(A) provided that the term “residential rental property” has the meaning given such term by § 167(j)(2)(B). See also section 3.02(2) of Rev. Proc. 87-57, 1987-2 C.B. 687, 689. Section167(j) and (k) (stricken by the Omnibus Budget Reconciliation Act of 1990) contained definitions of the terms "residential rental property" and "dwelling unit" substantially identical to the definitions in § 168(e)(2). Former § 167(j)(2)(B) defined residential rental property as a building or structure of which 80 percent or more of the gross rental income for the building or structure is rental income from dwelling units within the meaning of former § 167(k)(3)(C). The definition of dwelling unit in former § 167(k)(3)(C) is the same definition given that term in § 168(e)(2)(A)(ii)(I). According to GCM 35648, (Feb. 4, 1974), the authors of former § 1.167(k)-3(c)(1) of the Income Tax Regulations intended that the term “dwelling unit” encompass nursing homes, old age homes, and college dormitories. The housing arrangement described in the instant case is the same or similar to the “old age homes” discussed in GCM 35648.

While former § 167(j) and (k) does not apply to property placed in service after November 5, 1990, the guidance issued under former § 167(j) and (k) remains informative for determining whether a building or structure qualifies as residential rental property under § 168(e)(2)(A).

Former § 1.167(j)-3(b)(2)(i) provided that the term “gross rental income” means, generally, the gross amounts received from the use of or the right to use real property. The gross amount attributable to the furnishing of services that are usually or customarily attributable to the use of or the right to use real property constitutes gross rental income from the building. However, the gross amount attributable to the performance of significant services for the occupant that are other than those usually or customarily rendered in connection with the mere rental of rooms, such as maid service, does not constitute gross rental income from the building. See former § 1.167(j)-3(b)(2)(iii).

In accordance with former § 1.167(j)-3(b)(3), gross rental income from a building is gross rental income from a dwelling unit in such building only if it is attributable to or ordinarily associated with the use of, or the right to use, such unit as a living accommodation. If a portion of the building is used for a drugstore, grocery store, commercial laundry, or other commercial operation, the rent paid for such portion (including any amount paid for services in connection with such a commercial operation) is not rental income from a dwelling unit. Similarly, if pursuant to the terms of a lease or other agreement, a portion of a house or apartment is used as office space, such as a doctor’s office, the rent paid for that portion is gross rental income from the building but is not rental income from a dwelling unit.

If any portion of a building or structure is occupied by the taxpayer, former § 1.167(j)-3(b)(4)(iii) provided that the fair rental value of that portion is included in gross rental income in determining whether the building or structure qualifies as residential rental

property. The examples in former § 1.167(j)-3(b)(6) showed that if a building or structure is used to provide living accommodations on a rental basis and if any portion of that building or structure is occupied by the taxpayer, the fair rental value of the portion occupied by the taxpayer as a residence is treated as gross rental income from the building and as rental income from a dwelling unit, and that the fair rental value of the portion occupied by the taxpayer for a commercial activity (such as operating a store) is treated as gross rental income from the building but not as rental income from a dwelling unit.

Revenue Ruling 79-209, 1979-2 C.B. 97, concerned a taxpayer who owned a duplex consisting of two units of comparable value. The taxpayer leased one unit, and occupied the other unit. In applying the 80-percent test, the ruling states that both the rental unit and the owner-occupied unit are dwelling units, and so all rental income from the duplex (actual income from the leased unit, and implied income from the owner-occupied unit) was income from dwelling units. As a result, the leased unit (but not the owner-occupied unit) could be depreciated as residential rental property.

Section 168(e)(2)(A) defines property as a residential rental property by reference to a "building or structure," not to a dwelling unit or a portion of a dwelling unit. For a building or structure to be residential rental property, it must contain at least one dwelling unit that is actually rented to provide living accommodations. If the building or structure satisfies this threshold test, then the 80 percent of gross rental income test is applied.

In the facts in this advice, the rental units are bedroom apartments used to provide living accommodations within a building, and are not units in an establishment more than one-half of the units in which are used on a transient basis. Therefore, the rental units are dwelling units for purposes of § 168(e)(2). All units and associated common areas in the building, including the portions occupied by the taxpayers, are dwelling units, and no portion of the building is rented or used for commercial purposes outside of the taxpayers' adult home care business. Consequently, 100 percent of the gross rental income from the building is rental income from dwelling units, even after taking into account the use of the dwelling unit by the taxpayers. In applying the 80-percent test in this case, the $2,000.00 per month allocated to the services that the taxpayers provide for their residents does not constitute gross rental income from the building because the services (24 hour supervision and care for the residents, laundry service, maid service, transportation) are other than those usually or customarily rendered in connection with the mere rental of rooms[1]. Thus, in this case, the building is residential rental property.

[1] Upkeep of the house and landscaping are services customarily rendered in connection of the rental of rooms, and a portion of the monthly $2000 charge must be allocated to these services and included in both gross rental income from the building and rental income from dwelling units. The exclusion of charges for services other than those usually or customarily rendered in connection with the mere rental of rooms is relevant in the application of the 80 percent test only in the case of a building or structure containing both rental dwelling units and commercial rental space other than dwelling units. In the case of a building or structure comprised solely of dwelling units and associated areas (such as the instant

case), it is unimportant whether a particular cost for services is included in rental income or not, as 100 percent of gross rental income from the building is necessarily rental income from dwelling units.

Under § 168(e)(2), and the taxpayers should determine depreciation for the portion of the house leased as dwelling units by the residents (but not the portion of the house that is owner-occupied) over a 27.5 year recovery period (or a 40 year recovery period if the alternative depreciation system of § 168(g) applies).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This Chief Counsel Advice does not address whether § 280A limits the taxpayers' deductions for the use of a portion of their residence for business purposes.

In addition, the term "dwelling unit" is defined differently under § 280A(f)(1) than under § 168(e)(2)(A)(ii)(I). The conclusions in this Chief Counsel Advice concerning whether the bedroom apartments used in the taxpayers' business are dwelling units are limited to the analysis under § 168, and no inference should be drawn from this Chief Counsel Advice that these bedroom apartments are dwelling units for purposes of § 280A.

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Please call (202) 622-4930 if you have any further questions.

By: _____
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