INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

October 27, 2005

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200607020**
Release Date: 2/17/2006
Index (UIL) No.: 833.03-03, 833.02-00
CASE-MIS No.: TAM-137654-05/FIP:B4

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =
State A =
Year 1 =
Company 1 =
State B =
Subsidiary 1 =
Year 2 =
Company 2 =
State C =
Subsidiary 2 =
Year 3 =
Company 3 =
State D =
Subsidiary 3 =

Year 4 =
Company 4 =
State E =
Subsidiary 4 =
Year 5 =
Year 6 =
Company 5 =
State F =
Subsidiary 5 =
Organization =
Statute 1 =

ISSUE(S):

1. Whether the conversion of Taxpayer from a not-for-profit mutual insurance company to a for-profit stock insurance company, which involved the offering of stock and securities traded on a public exchange, constitutes a material change in its operations or structure as contemplated by § 833(c)(2)(C) of the Internal Revenue Code?

2. If such a conversion is a material change in structure, does the change negate the application of §§ 833(a)(2) and (a)(3) to Taxpayer and Taxpayer's subsidiaries?

3. If such a conversion is a material change in structure, does the change preclude application of the benefits of § 1012 of the Tax Reform Act of 1986 (P.L. 99-514)(October 22, 1986) (the Act)?

CONCLUSION(S):

1. The conversion of Taxpayer from a not-for-profit mutual insurance company to a for-profit stock insurance company constitutes a material change in its structure as contemplated by § 833(c)(2)(C) of the Internal Revenue Code.

2. Taxpayer's conversion negates the application of §§ 833(a)(2) and (a)(3) to Taxpayer and Taxpayer's subsidiaries for the years involved.

3. The material change precludes application of the benefits of § 1012 of the Tax Reform Act of 1986.

FACTS:

Years ago, Taxpayer was incorporated as a mutual insurance company under the law of State A. Taxpayer engaged in several acquisitive transactions. In Year 1, Company 1, a mutual insurance company under the law of State B, merged into

Taxpayer such that Company 1's business was transferred to Taxpayer's newly formed wholly owned subsidiary, Subsidiary 1, a stock insurance company under the law of State B. In Year 2, Company 2, a mutual insurance company under the law of State C, merged into Taxpayer such that Company 2's business was assumed by Taxpayer's newly formed Subsidiary 2, a stock insurance company under State C law; during the years involved Subsidiary 2 was a second-tier wholly owned subsidiary of Taxpayer. In Year 3, Company 3, a mutual insurance company under the law of State D, merged into Taxpayer such that Company 3's business was transferred to Taxpayer's newly formed wholly owned Subsidiary 3, a stock insurance company under State D. In Year 4, Company 4, a mutual insurance company under the law of State E, converted to a stock insurance company under the law of State E and was acquired by Taxpayer as a wholly owned subsidiary (hereafter Subsidiary 4).

In Year 5, Taxpayer converted from a mutual insurance company to a publicly traded stock insurance company under the law of State A, issuing stock and securities.

In Year 6, Taxpayer acquired the outstanding stock of Company 5, a stock company under the law of State F. Company 5 had previously been a mutual insurance company under the law of State F that years ago converted to a for-profit stock company. The assets of Company 5 were transferred to newly formed Subsidiary 5, also a stock company under the law of State F.

Prior to these transactions, Taxpayer and each Company were existing Blue Cross and Blue Shield organizations within the meaning of § 833(c). In computing their taxable income for Year 5, Subsidiaries 2, 3, and 4 claimed the deduction provided by § 833(a)(2) and Taxpayer and Subsidiaries 1, 2, 3, and 4 used the method of computing basis provided by § 1012(c)(3)(A)(ii) of the Tax Reform Act of 1986. In computing their taxable income for Year 6, Subsidiaries 2 and 4 claimed the deduction provided by § 833(a)(2) and Taxpayer and Subsidiaries 1, 2, 3, 4, and 5 used the method of computing basis provided by § 1012(c)(3)(A)(ii) of the Tax Reform Act of 1986.

LAW AND ANALYSIS:

Issue 1

Section 833(a)(1) provides that existing Blue Cross or Blue Shield organizations are subject to tax as if they were stock insurance companies under Part II of subchapter L.

Section 833(a)(2) provides for a special deduction determined under § 833(b), which is the excess (if any) of 25 percent of the sum of (i) the claims incurred during the taxable year and liabilities incurred during the taxable year under cost-plus contracts and (ii) expenses incurred during the taxable year in connection with the administration, adjustment, or settlement of claims in connection with the administration of cost-plus contracts, over the adjusted surplus as of the beginning of the taxable year. Section

833(b)(2) provides that the deduction determined under § 833(b)(1) for any taxable year shall not exceed taxable income for such taxable year (determined without regard to such deduction). Section 833(a)(3) provides that the reduction to unearned premiums set forth in § 832(b)(4)(B) shall not apply to § 833 organizations.

Section 1012(c)(3)(A)(ii) of the Act provides that in the case of any existing Blue Cross or Blue Shield as defined in § 833(c)(2) that, for purposes of determining gain or loss, the adjusted basis of its assets is deemed equal to the assets' fair market values as of the first day of its first taxable year beginning after December 31, 1986.

Section 833 applies to those organizations described as either (A) an "existing Blue Cross or Blue Shield organization" as defined in § 833(c)(2), or (B) an organization meeting the requirements of § 833(c)(3). Section 833(c)(1).

Section 833(c)(2) defines the term "existing Blue Cross or Blue Shield organization" to mean: (1) any Blue Cross or Blue Shield organization that was in existence on August 16, 1986, (2) that was determined to be exempt from tax for its last taxable year beginning before January 1, 1987, and (3) with regard to which no material change has occurred in the operations of such organization or in its structure after August 16, 1986, and before the close of the taxable year. Furthermore, any successor to an organization that was an existing Blue Cross or Blue Shield organization as defined in § 833(c)(2), and any organization resulting from the merger or consolidation of organizations which meet the requirements of § 833(c)(2) are to be treated as existing Blue Cross or Blue Shield organizations for purposes of § 833 to the extent permitted by the Secretary of the Treasury.

Section 833(c)(3) sets forth six requirements that other (new) organizations must meet including subparagraph (A)(vi) that no part of its net earnings inures to the benefit of any private shareholder or individual.

The Conference Report regarding § 833 (section 1012 of the Act), 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-344 to II-351 (1986), 1986-3 (Vol. 4) C. B. 344 to 351, contains certain principles that are to be applied to determine whether a material change in operation or structure has occurred under § 833(c)(2).

> First, the merger or split up of one or more Blue Cross or Blue Shield organizations will not constitute a material change in operation or structure.
>
> Second, if a Blue Cross or Blue Shield organization acquires a new line of business or is acquired by another business (other than a health business), the acquisition does not constitute a material change in operations or structure of the organization if (1) the assets of the other business are a de minimis percentage (i.e., less than 10 percent) of the assets

of the existing Blue Cross or Blue Shield organization at the time of the acquisition, or (2) the taxpayer can demonstrate to the Secretary of the Treasury that, based on all the facts and circumstances, the acquisition does not constitute a material change in operations or structure of the existing Blue Cross/Blue Shield organization.

Third, a material change in operations occurs if an existing Blue/Cross Blue Shield organization drops high risk coverage or substantially changes the terms and conditions under which high risk coverage is offered by the organization from the terms in effect as of August 16, 1986. A change in high risk coverage is considered substantial if the effect of the change is to defeat the purpose of high risk coverage. High risk coverage for this purpose generally means the coverage of individuals and small groups to the extent the organization (1) provides such coverage under the specified terms and conditions as of August 16, 1986, or (2) meets the statutory minimum definition of high risk coverage for new organizations. A material change in operations does not occur if an existing organization alters its operations to provide high risk coverage that meets the minimum standards under the conference agreement for new Blue Cross/Blue Shield organizations.

For example, if an existing Blue Cross/Blue Shield organization provides open enrollment to all individuals and small groups of less than 5 individuals, the organization could redefine a small group for purposes of this coverage to mean the lesser of 15 individuals or the minimum number of individuals required for small group under state law. Such a redefinition of a small group (from 5 to 15 individuals) would not be considered a material change in operations because the organization would meet the minimum standard for a new organization with respect to small group coverage.

On the other hand, if an existing Blue Cross/Blue Shield organization provides, as of August 16,1986, high risk coverage to individuals and small groups without a premium or price differential to take into account the high risk nature of the business, a change in premium structure for such individual and small group coverage that has the effect of creating a significant price differential to take account of the high risk nature of the business would be considered a material change in operations.

During the Senate debate regarding this provision of the Tax Reform Act of 1986, The Chairman of the Senate Finance Committee (Senator Packwood) discussed the meaning of the material change in operations and structure provision with another member of the Finance Committee (Senator Chafee). The following is one of their exchanges:

> MR. CHAFEE: I would appreciate the chairman's clarifying some aspects of that important provision. The Bill limits the use of the deduction to existing Blue Cross and Blue Shield organization which do not materially change their operations after the date of the conference agreement. Does this mean that any change in the organization's operations after that date will cause it to lose the deduction?
>
> MR. PACKWOOD: Certainly not. The purpose of the limitation is to deny the deduction to the organization only if it makes a change in its operations which is so material that the change has the effect of eliminating coverage for a high-risk segment of its business. An example of such a material change would be the elimination of coverage for individuals.

123 Cong. Rec. 513957 (daily ed. Sept. 27, 1986).

Subsequently, Congressman Rostenkowski, the Chairman of the Ways and Means Committee, made a statement on October 2, 1986, with respect to several of the colloquies between Senator Packwood and other members of the Senate. Although Mr. Rostenkowski stated his belief that certain aspects of the colloquies on § 833 did not reflect his understanding of the intent of the conferees, his summary of the intent of the conferees with respect to material change in operations was consistent with the view expressed by Mr. Packwood. Rep. Rostenkowski said, in part:

> It was not the intent of the conferees to prevent an existing Blue Cross and Blue Shield organization from making normal adjustments in their business practices, such adjustments to reflect new trends in cost containment or adding new coverages. However, it is my understanding that any change in business practice that either eliminates coverage of high risk individuals or small groups or that has the effect of eliminating such coverage is a material change in structure or operation. For example, a premium increase that has the effect of making high-risk coverage unavailable because of the cost of such coverage is treated as a material change.

132 Cong. Rec. E3391 (daily ed. Oct. 2, 1986).

The General Explanation of the Tax Reform Act of 1986 (the "Blue Book"), at pages 587-588, prepared by the staff of the Joint Committee on Taxation (1987), provides:

> The merger or split up of one or more Blue Cross or Blue Shield organizations, or the conversion to mutual status under local law is not a material change in operations or structure.
>
> A material change is presumed to occur if an organization, on or after August 16, 1986, ceases to offer coverage for individuals or small groups or conversion coverage for those individuals who leave an employment-based group because of termination of employment. A material change generally occurs if an organization, which on August 16, 1986, offered individual coverage that allowed enrollment regardless of medical condition, modifies enrollment practices for that coverage to exclude certain individuals because of a preexisting medical problem.
>
> A material change in operations does not occur if the plan increases its premium rates to reflect increases in health care costs or makes normal changes in products or services to respond to changes and developments generally in the health care environment. Thus, this material change in operations rule is not intended to prevent a plan from making normal adjustments in their business practices, such as adjustments to reflect new trends in cost containment or adding new coverages.
>
> Any change in business practice that eliminates coverage of high-risk individuals or small groups or has the effect of eliminating such coverage, however, is a material change in structure or operations. For example, a premium increase that reflects normal increases in medical costs is not itself treated as a material change. On the other hand, a premium increase that has the effect of making high risk coverage unavailable because of the cost of such coverage is treated as a material change.
>
> Similarly, a material change generally will occur if an organization after August 16, 1986, ceases offering individual or small group coverage in a defined geographic

> area due to a concentration of high risk individuals in that area. In addition, a material change generally will occur if an organization institutes, subsequent to August 16, 1986, a procedure to identify particular individuals within the pool of individual enrollment, reassesses their individual risk due to excessive utilization, and cancels their coverage.
>
> The material change rule is not intended to prevent existing Blue Cross and Blue Shield organizations from changing their high risk coverage to respond better to the needs of that population. For example, a material change would not occur if the organization introduced a preferred provider arrangement or a managed care product for individual high risk coverage that included financial incentives or requirements to use more cost effective providers or benefits (e.g. home health or hospice care rather than hospitalization). The material change rule also is not intended to prevent existing Blue Cross and Blue Shield organizations from establishing special coverages that recognize healthy lifestyles. For example, a material change would not occur if smokers were charged a higher premium than non-smokers.

Sections 833 and 501(m) changed Taxpayer's status from being tax-exempt to taxable for federal tax purposes for taxable years after December 31, 1986. This, of course, did not impact Taxpayer's corporate structure which is governed by state law and the rules of the Organization. The Organization to which Taxpayer belonged lifted its long standing and pre-1986 ban and allowed its members to become for-profit entities. As a result of removing this restriction, Taxpayer as well as many other members of the Organization began the process of converting to a for-profit entity under state law.

The first issue is whether Taxpayer's conversion from a not-for-profit mutual insurance company to a for-profit stock insurance company constitutes a material change in its operations or structure as contemplated by § 832(c)(2)(C) of the Internal Revenue Code.

In addressing these issues we must pay close attention to the words used in the statute, their relationship to other words and statutory provisions, and any guidance that legislative history may shed on the intent of Congress. Section 833(c)(2)(C) is drafted as if there is more than a single standard of "operations and structure" or "operations or structure". There are several words that are inserted between "operations" and "structure". The statute states that no material change has occurred "in the operations of such organization or in its structure". We conclude that the statute sets forth two

separate standards, that is, one of “operations” and one of “structure”. Further examination of the statute and legislative history confirms this analysis.

To continue to qualify as an existing Blue Cross or Blue Shield organization under § 833(c)(2), there is a requirement that no material change has occurred in the operations of such organization or its structure after August 16, 1986, and before the close of the taxable year. The flush language of § 833(c)(2) provides to the extent permitted by the Secretary, any successor to any organization meeting the requirements of § 833(c)(2)(C), any organization resulting from the merger or consolidation of organizations each of which has meet such requirements, shall be treated as an existing Blue Cross or Blue Shield organization. In effect, this language provides that such changes are not considered material changes for this provision without addressing whether such changes should be labeled that of “operations” or “structure”. The legislative history sets forth three principles that should be used in determining whether or not a material change in operations or structure has occurred. The statute lists three items in the flush language: successor, merger, and consolidations. The first principle in the legislative history only deals with mergers and split-ups. The second principle deals with certain acquisitions. The flush language and the first two principles cover changes that are more structural in nature but could be viewed as one of operations in a general sense but the legislative history states that these items are not material changes no matter how many standards or tests are in the statute. In other words, the changes are not material and this conclusion is a more consistent reading of the flush language without having to differentiate between “operations” or “structure”. Our analysis regarding statutory construction is confirmed by examining the third principle of the legislative history. This third principle is limited to “operations” and does not refer to the “structure” of an organization. As important is the lengthy explanation of what the Congress viewed as critical for the organizations to continue providing in order to obtain certain tax benefits. These organizations must continue to offer high risk coverage in their “operations”. A change in operations appears to be limited to dropping high risk coverage or substantial changes in the term and conditions under which high risk coverage is offered from the terms and conditions in effect as of August 16, 1986. The focus that the legislative history places on changes to high risk coverage implies that this was the predominant issue that they were concerned about regarding a material change in operations.

Section 833(c)(2)(C) also requires that any change must be “material”. Words or terms in a statute should ordinarily be given their usual meaning. United States v. Murphy, 35 F. 3rd 143, 145 (4th Cir. 1994). The word “material” is defined as 1. being of real importance or great consequence; 2. substantial, essential; 3. requiring serious consideration by reason of having a certain or probable bearing on the proper determination of a law case. Webster’s Third New International Dictionary (Merriam-Webster Inc. Publishers 1986).

In summary, we find that section 833(c)(2)(C) sets forth two separate tests for continued qualification as an existing Blue Cross or Blue Shield Organization: there

must be (1) no material change in operations, and (2) no material change in structure. Furthermore, the test regarding "operations" deals with high risk coverage. Because the facts in this case do not deal with high risk coverage, we must consider the Taxpayer's conversion to a for-profit stock company and its issuance of publicly traded stock and securities against the test of material change in structure.

Taxpayer's conversion from a non-profit non-stock entity to a for-profit stock entity involved changing Taxpayer's articles of incorporation with the effect of changing how Taxpayer is governed under state law. This change resulted in significant changes to the fiduciary responsibility of the directors. The issuance of stock and securities clearly created rights and also responsibilities that Taxpayer was not previously subject to as a non-stock non-profit entity. Previously, Taxpayer was a mutual insurance company, with customers who also held equity/ownership interests. Upon conversion and issuance of stock, Taxpayer had a new relationship with equity owners who are not necessarily policyholders but are instead concerned only with profits. There is a fundamental difference between a non-profit mutual insurance company and a for-profit stock insurance company. See Statute 1. The issuance of stock and securities and its consequent fundamental change in an organization's obligations and relationships is such a significant change that we conclude that the issuance of stock is the event that effectively manifests § 833's prohibition against a material change in structure. Clearly these changes to an organization's structure must be classified as a material change in structure under § 833(c)(2)(C). To reach a contrary conclusion would render the material change in structure limitation in § 833 a nullity.

Our conclusion regarding material change in structure is consistent with other provisions in § 833. First, the literal language of § 833(a)(1) states that such organizations shall be taxable under this part in the same manner as if they were a stock insurance company. At the time this Code section was enacted, Congress knew that none of the entities subject to it were stock insurance companies. Thus, the prohibition against a change in structure was put in the statute. Second, the flush language of § 833(c)(2)(C) states that to the extent permitted by the Secretary, any successor to an organization meeting the requirements of the preceding sentence or any organization resulting from the merger or consolidation of organizations each of which has met such requirement, shall be treated as Blue Cross or Blue Shield organizations. The Conference Report provides that a merger or split up of one or more Blue Cross or Blue Shield organizations will not be treated as a material change in structure or operations. The Blue Book adds that a conversion to a mutual under local law will not constitute a material change in operations or structure. Both the statute and its legislative history recognized that there would be future structural changes to these organizations and set limits to what would be recognized as non-material changes. Third, § 833(c)(3)(A)(vi) dealing with other (new) organizations that can obtain the tax benefits at issue here requires that no part of the entity's net earnings inure to the benefit of any private shareholder or individual. The material change in structure language of § 833(c)(2)(C) is the analog to this provision for those existing Blue Cross and Blue Shield organizations under § 833(c)(1)(A). Finally, § 833(c)(4)(B)(i), which

was added in 1996, continues the prohibition against for-profit entities by applying this particular paragraph only to non-profit organizations.

Accordingly, the Year 5 conversion of Taxpayer from a not-for-profit mutual insurance company to a for-profit stock insurance company, which involved the offering of stock and securities, constitutes a material change in its structure as contemplated by § 832(c)(2)(C) of the Internal Revenue Code. For Year 5, § 833 did not apply to Taxpayer and Subsidiaries 1, 2, 3, and 4; for Year 6, § 833 did not apply to those entities nor to Subsidiary 5.

Issue 2

Under § 833(c)(2)(C), an entity is no longer an existing Blue Cross or Blue Shield organization if there is no material change "before the close of the taxable year". Thus, for each taxable year, the determination point is the end of the year. This means that the entity that has a material change is treated as not being an existing Blue Cross or Blue Shield organization for the entire taxable year in which the material change occurred. There is no prorating of any of the § 833 tax benefits.

Issue 3

Section 1012 (c)(3)(A) of the Act states that the special rules of § 1012(c)(3)(A)(ii) apply to existing Blue Cross and Blue Shields organizations as defined in § 833(c)(2) of the Code which would include the material change in structure language of subsection (c)(2)(C). Therefore, an entity that is no longer described by § 833(c)(2) can not claim the benefits of § 1012(c)(3)(A)(ii).

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.