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Date:
April 22, 2014

Legend

Year Q	=
Taxpayer	=
State X	=
Company	=
Foundation	=
State Y	=
Date Z	=

Dear :

This is in response to the letter submitted by your authorized representatives requesting a ruling that the transaction described below will not result in a material change, within the meaning of § 833(c)(2) of the Internal Revenue Code, in Taxpayer's operations or structure, so that Taxpayer will continue to qualify during Year Q as an existing Blue Cross or Blue Shield organization under § 833.

FACTS

Taxpayer for many years has been a State X nonprofit health service corporation. As an independent, locally-operated licensee of the Blue Cross and Blue Shield Association, Taxpayer provided health care coverage to State X residents. Taxpayer also provided stop-loss insurance for employers that covered most of the members covered by Administrative Services Only (ASO) contracts. Taxpayer's mission was to

provide State X residents with affordable, innovative health and wellness solutions, to help them lead healthier lives, and more generally to improve the quality, and availability, and awareness of healthcare programs and services for State X residents.

Company is a State Y mutual legal reserve company operating as a nonprofit health care service plan. Company has Blue Cross and Blue Shield plans in several states. Company's articles of incorporation specify its nonprofit status, and its bylaws prohibit inurement of its profits to any person.

Taxpayer represents that prior to the transaction described below, it qualified as a Blue Cross or Blue Shield organization under § 833(c)(2) because it was in existence on August 16, 1986, it was exempt from tax under § 501(c)(4) for its last taxable year beginning before January 1, 1987, and it did not undergo any material change in operation or structure after August 16, 1986.

Taxpayer's board of directors decided to have Taxpayer form a business alliance with another Blue Cross and Blue Shield plan. Subsequently, Taxpayer and Company entered into an asset purchase agreement and sale ("Transaction"). In the Transaction, Taxpayer transferred its insurance and certain other operations and assets to Company. The assets transferred to Company include Taxpayer's name, workforce, subscriber network, provider contracts, and going concern and goodwill. The acquired business is a nonprofit Blue Cross and Blue Shield plan that Company operates as a division of Company in State X. Taxpayer's members became Company members without a break in coverage. Company assumed Taxpayer's unpaid claims liabilities, except that Taxpayer retained the resisted claims and other liabilities, under both insured and ASO plans that are in litigation ("Retained Claims"). The Retained Claims include all litigation against Taxpayer initiated before Date Z, as well as claims against Taxpayer for acts or omissions occurring before that date that give rise to litigation. The Retained Claims involve issues such as the scope of policy exclusions, the amount of allowable premiums, breach of contract allegations, liability for attorneys' fees, and similar issues. Taxpayer retained significant assets from which to satisfy any liabilities it is ultimately determined to owe with respect to the Retained Claims. The assets retained by Taxpayer include an escrow fund to protect Company against possible breach by Taxpayer with respect to certain requirements of the purchase agreement, including the requirement that Taxpayer pay the amount of any Retained Claims that are ultimately determined to be due. Taxpayer may charge amounts its pays on the Retained Claims, as well as defense costs on such Retained Claims, against the escrow fund.

Taxpayer and Company filed an application seeking approval of the Transaction. After hearings on the application, both the State X Commissioner of Insurance and the State X Attorney General approved the Transaction. The State X Attorney General's final order ("Final Order") approving the Transaction points out that under applicable State X law, the Attorney General must ensure that no part of Taxpayer's public assets improperly benefit any private party. Further the Attorney General must require that a

fair market value is paid for the purchased assets and that the charitable assets of Taxpayer are distributed to a new or existing foundation to be held in trust and used in continuance of Taxpayer's mission: to provide financial support to improve the quality, availability, and awareness of healthcare programs and services for State X residents. Accordingly, the State X Attorney General created Foundation as a § 501(c)(3) charity with a mission statement that closely approximates the mission of Taxpayer. The Final Order determines that the agreed purchase price represented a fair market value for the purchased assets in the Transaction (net of liabilities assumed by Company). The Final Order specifies that because the purchased assets were public assets, the purchase price must be transferred by Company directly into Foundation to continue Taxpayer's mission for the benefits of State X residents into the future.

As required by the Final Order, upon closing of the Transaction, Company paid the sale proceeds to Foundation, not Taxpayer, and Taxpayer transferred to Company the purchased assets and assumed liabilities. At the same time, Taxpayer gave up the right to use the Blue Cross and Blue Shield name and amended its articles of incorporation to change its name. As part of those amended articles, Taxpayer's status was changed to a non-member non-profit mutual benefit corporation, and its stated purposes were amended to include "to wind up its operations as a non-profit health service corporation…". In addition, Taxpayer ceased writing new insurance policies and providing healthcare services.

As required by the Final Order, on Date Z, Taxpayer filed a Plan of Dissolution with the State X Department of Justice. Under this plan, Taxpayer is working to wind up its health insurance and administrator business, liquidating its assets and defending and processing the Retained Claims. Taxpayer is also working on arrangements for the ordered sale of its remaining assets, including an investment portfolio, buildings (previously used by Taxpayer as office space), a subsidiary corporation, and receivables due. Consistent with Taxpayer's charter, the provisions of State X law, and the Final Order, Taxpayer will pay to Foundation all its residual net assets, after all its liabilities (including federal income tax, if any) have been satisfied.

LAW AND ANALYSIS

Section 833 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. To be subject to the provisions of § 833, § 833(c)(1) provides that an organization must be (A) an "existing Blue Cross or Blue Shield organization" as defined in § 833(c)(2), or (B) an organization described in § 833(c)(3). Section 833(c)(2) defines the term "existing Blue Cross or Blue Shield organization" to mean any Blue Cross or Blue Shield organization if (A) such organization was in existence on August 16, 1986; (B) such organization is determined to be exempt from tax for its last taxable year beginning before January 1, 1987; and (C) no material change has occurred in the operation 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 met the requirements of § 833(c)(2), are treated as existing Blue Cross or Blue Shield organizations for purposes of § 833 to the extent permitted by the Secretary of the Treasury.

The Conference Report regarding § 833 (section 1012 of the Tax Reform Act of 1986), 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 the following principles that are to be applied to determine whether a material change in operations or structure has occurred under § 833(c)(2):

> First the merger or split up of one or more Blue Cross/Blue Shield organizations will not constitute a material change in organization or structure.
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> Second, if an existing Blue Cross/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 operation or structure 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 /Blue Shield organization at the time of 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 operation or structure of the existing Blue Cross/ Blue Shield organization.
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> Third, a material change in operations occurs if an existing Blue Cross/Blue Shield organization drops its high risk coverage or substantially changes the terms and conditions under which high risk coverage is offered by the organization from the terms and condition in effect as of August 16, 1986. A change in the 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.

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 organizations 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?
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> 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 elimination of coverage for individuals.
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> 123 Cong. Rec. 513957 (daily ed. Sept. 27, 1986).

Subsequently, Representative Rostenkowski, the Chairman of the Ways and Means Committee, made a statement on October 2, 1986, with respect to several of the colloquies between Sen. Packwood and other members of the Senate. Although Rep. 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 Sen. 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 as 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 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.
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> 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), states that the merger or split up of one or more existing Blue Cross or Blue Shield organizations, or the conversion to a mutual company status under local law, will not constitute a material change in operations or structure.

The Blue Book provides that 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.

The Blue Book also states that 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 development generally in the health care environment. The 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 either eliminates coverage of high-risk individuals or small groups or that has the effect of elimination such coverage, however, is a material change in structure or operation. 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, reassess their individual risk due to excessive utilization, and cancels their coverage.

The Blue Book states that the material change rule is not intended to prevent existing Blue Cross or 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 or Blue Shield organizations from establishing special coverages that recognize health lifestyles. For example, a material change would not occur if smokers were charged a higher premium than non-smokers.

Taxpayer qualifies under § 832(c)(2) as an existing Blue Cross or Blue Shield organization. It was in existence as of August 16, 1986; it was tax exempt for its last taxable year beginning before January 1, 1987; and it did not undergo any material change in operation or structure after August 16, 1986. The issue, therefore, is whether the Transaction resulted in a material change in Taxpayer's operations or structure as contemplated by § 833(c)(2)(C) for Year Q.

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. 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 to 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. The merger or split up of one or more Blue Cross or Blue Shield organization, or the conversion to a mutual company under local law, will not constitute a material change in operations or structure. There is not material change in operations or structure in the acquisition of a new line of business or the acquisition by another business (other than a health business) if the assets are a de minimis amount (i.e., less than 10 percent) of the existing Blue Cross or Blue Shield organization at the time of the acquisition. Although words generally carry their usual and customary meaning, we believe Congress used "operations" in a narrow context. A change in operations appears to be limited to dropping high risk coverage or substantial changes in the terms 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.

Though neither § 833 nor its legislative history specifically addresses the Transaction, the closing of the Transaction on Date Z does not result in a material change in Taxpayer's structure. Until its final dissolution, Taxpayer will remain a nonprofit corporation under State X law, with its net assets committed to the Foundation and the shared legal purpose of improving the quality, availability, and awareness of healthcare programs and services for State X residents. After all liabilities are resolved, Taxpayer will transfer all its net assets to the Foundation to continue Taxpayer's mission, and then dissolve. Taxpayer's continuing its existence after closing the Transaction, to wind-up its operations, will result in no change in Year Q in structure.

Similarly, there is no change in Taxpayer's operations. Taxpayer entered into the Agreement to enable its members to receive seamless continuation of healthcare services, from a local, nonprofit Blue Cross Blue Shield Plan with the same personnel, and with improved economies of scale and financial strength, to enhance the plan's ability to perform Taxpayer's mission far into the future. Since the closing date, Company has conducted Taxpayer's former operations as a division of Company in substantially the same manner as before. Company continues this old business of Taxpayer without any change affecting high-risk coverage, and without material change.

Legislative history specifies that a merger is not a material change in operations. But to best accomplish certain business goals, a merger in this case was not feasible. Instead it was necessary for Taxpayer to retain its claim liabilities in litigation. Completing the Transaction as an asset sale facilitated Taxpayer's retention of public assets not necessary to continuation of the transferred operations, so those assets could be transferred by Taxpayer to the Foundation consistent with State X law. Liquidating those assets, and adjusting and litigating liability for the Retained Claims will take some time, so as a practical matter Taxpayer cannot dissolve immediately. But from the standpoint of the policy behind § 833, this delay should not result in loss of § 833 status in Year Q.

Taxpayer simply is doing what a § 833 entity does when it is winding up its § 833 operation, consistent with its nonprofit charter to improve healthcare in its state—after selling what it can in a way that provides members with continuing coverage, it runs off and liquidates what remains. Taxpayer's principal activity during the wind-up period will be liquidating assets and adjusting and litigating liability for the retained resisted claims; this activity is entirely consistent with § 833 status. This conclusion is supported by the principle that an insurance company that is winding up its operations and running off its risks under its remaining insurance contracts is still an insurance company for federal income tax purposes. See H.R. Conf. Rep. No 108-457, 2d Sess. 50-51 (2004) which states "[i]t is not intended that a company whose sole activity is the run-off of risks under the company's insurance contracts be treated as a company other than an insurance company, even if the company has little or no premium income."

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Sheryl B. Flum
Branch Chief
(Financial Institutions & Products)

cc: