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Department of the Treasury
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Date:
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Parent =

Subsidiary =
State 1 =
State 2 =
State 3 =
State 4 =
State 5 =
Agency =
Government =
Business
x-year =
Rating System =
z% =
Newco 1 =

Newco 2 =

Newco 3 =

Newco 4 =

Newco 5 =

Dear :

This is in response to an October 19, 2015 letter from your authorized representative (with supplemental submissions dated January 20, 2016, February 22, 2016, and March

21, 2016) requesting rulings concerning the application of § 833 of the Internal Revenue Code to the proposed transaction, described below (the “Proposed Transaction”).

FACTS

Parent is a State 1 mutual legal reserve company and the common parent of an affiliated group of corporations (the “Consolidated Group”) that file a consolidated U.S. federal income tax return. Parent is a Blue Cross and Blue Shield (BCBS) organization that operates BCBS plans in State 1, State 2, State 3, State 4, and State 5. Parent markets, underwrites, and services health insurance contracts. In general, Parent sells these contracts through both its own employees and independent brokers.

The Agency has approved Parent to sell Government Business contracts to individuals. Government Business is subject to uniform federal government standards. In general, Government Business contracts have x-year term. The federal government reimburses Parent for the Government Business health risks it insures. The reimbursement rates are affected by Parent’s performance ratings determined pursuant to Agency’s Rating System.

Government Business is a small component (less than z% of total premium income) of Parent’s insurance business. Parent conducts Government Business directly in State 1, State 2, State 3, and State 4, but Parent conducts Government Business in State 5 through Subsidiary. Subsidiary is a directly, wholly-owned subsidiary of Parent that is not an “existing Blue Cross or Blue Shield organization” as that term is used in § 833(c)(2). All of the underwriting, claims, actuarial, investment management, membership additions, cancellations, customer billing, hospital and physician claim processing, and other administrative functions relating to Subsidiary’s Government Business are managed by Parent employees.

Proposed Transaction

Parent’s business motivations for the Proposed Transaction include (1) establishing and maintaining a separate Rating System performance rating for Government Business in each state and (2) mitigating legal liability risks associated with Government Business.

As described below, Parent proposes to undertake, pursuant to one overall plan, the following steps:

1. Parent will form five new insurance companies: (i) Newco 1, a State 1 corporation, (ii) Newco 2, a State 2 corporation, (iii) Newco 3, a State 3 corporation, (iv) Newco 4, a State 4 corporation, and (v) Newco 5, a State 5 corporation (collectively the “Newcos”). Parent will capitalize the Newcos with sufficient capital for each to satisfy relevant minimum capital requirements, as needed to conduct Government Business, and will transfer the State 1, State 2,

State 3, and State 4 Government Business it conducts to the respective state Newco. Subsidiary will make a constructive distribution of its Government Business to Parent and Parent will transfer that business to Newco 5. Each Newco will be licensed as an insurance company solely in its respective state and will be engaged in Government Business.

2. Parent will continue to perform its historic administrative functions through its own employees. Each Newco will enter an arm's length administrative services agreement (the "ASA") with Parent pursuant to which Parent will provide each Newco all claims processing and payment, premium price setting, internal audit, legal, financial reporting, facilities, voice and data communication, data processing and other technology, banking and investment management, general administrative, procurement, compliance, security, human resources, and other management, operational and administrative services.

3. Parent will guarantee each Newco's obligations for the insurance contracts they issue.

4. Each Newco will commence Government Business in the state in which it resides and is licensed. Each of the Newcos, except Newco 5, will offer to renew Government Business contracts issued by Parent as those contracts expire and will seek new Government Business using the capital provided by Parent. Newco 5 will seek new Government Business using capital provided by Parent, and also will seek to renew existing Government Business contracts issued by Subsidiary as those contracts expire.

Parent will be the sole shareholder of each Newco. Each Newco will have its own board of directors and officers, but will not have any direct employees. Therefore, each Newco will rely on Parent's employees to perform all of its operational and administrative functions. It is expected that each Newco will join the Consolidated Group upon its formation.

Additional Representations

Parent makes the following additional representations:

1. Parent is a BCBS organization that was in existence on August 16, 1986.

2. Parent was exempt from tax for its last taxable year beginning before January 1, 1987.

3. Parent has not changed its health benefits coverage for individuals or small groups or its capital structure since August 16, 1986, in any way that would

result in a material change in operations or structure as described in the legislative history to § 833.

4. Parent is an "existing Blue Cross or Blue Shield organization" as that term is used in § 833(c)(2).

5. Parent has no plan or intention to dispose of any ownership interest in any Newco to an unrelated party.

6. Each Newco's operations will be limited to conducting Government Business and other health insurance business.

7. Each Newco will be licensed to conduct insurance business in the state in which it resides and will be regulated by the insurance commissioner or other insurance regulatory body for that state.

8. Each Newco will be licensed by the BCBS Association and use the BCBS Association trademark and name for the respective state in which it resides.

9. Parent's Management intends to allocate Parent's existing adjusted surplus between and among Parent and the respective Newcos based on the relative number of policyholders in each entity. Such allocation methodology will not favorably impact the § 833(b) deductions to be claimed by the Consolidated Group (including the Newcos) in the year of such allocation relative to the § 833(b) deduction that would be claimed by Parent in the absence of the Proposed Transaction.

10. It is intended that the business practices of each Newco will be consistent with Parent's past practices, and will resemble Parent in all material respects (including using the BCBS Association trademark and name), so that the Proposed Transaction will not cause any change to high-risk individual or small group coverage, individually or in the aggregate, relative to such coverage if Parent had continued to directly conduct the transferred business.

11. None of the Newcos intend to terminate their high-risk coverage of individuals or small groups or materially change the eligibility, terms, or conditions under which high-risk coverage is offered relative to the terms and conditions under which it is offered in the market place.

12. Parent will continue to provide high-risk coverage of individuals and small groups following the Proposed Transaction.

REQUESTED RULINGS

Parent request rulings that the Proposed Transaction will not be considered a material change in its operations or structure under § 833(c)(2) and that, after the Proposed Transaction, each Newco will be treated as an "existing Blue Cross or Blue Shield organization" for purposes of § 833.

LAW AND ANALYSIS

Section 833 provides that a qualifying BCBS organization is entitled to: (1) treatment as a stock insurance company; (2) a special deduction under § 833(b); and (3) computation of unearned premium reserves under § 832(b)(4) based on 100 percent, and not 80 percent, of unearned premiums. To qualify for 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).

Section 833(c)(2) defines "an existing Blue Cross or Blues Shield organization" as 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, among other requirements, that 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.

Also, to the extent permitted by the Secretary, any successor to an organization meeting the requirements of the preceding sentence, and any organization resulting from the merger or consolidation of organizations each of which met such requirements, shall be treated as an existing Blue Cross or Blue Shield organization. Section 833(c)(2).

The legislative history describes the principles that the Secretary shall apply in determining whether a material change in operations or structure has occurred:

> First, the merger or split up of 1 or more existing Blue Cross/Blue Shield organizations will not constitute a material change in operation or structure.
>
> 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 operations 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 the acquisition, or (2) the taxpayer can clearly 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 its high risk coverage or substantially changes the terms and conditions under which high risk coverage is offered…

HR Conf No 99-841, 99th Cong, 2nd Sess (Sept 18, 1986).

Neither § 833 nor the related legislative history specifically addresses the Proposed Transaction. However, by explicitly stating that the "split up of 1or more existing Blue Cross/Blue Shield organizations will not constitute a material change in operation or structure," the legislative history articulates Congressional intent to permit an existing Blue Cross or Blue Shield organization to transfer its business to multiple wholly-owned "successor" subsidiaries provided they continue to operate the existing Blue Cross or Blue Shield organization's business.

Parent is "an existing Blue Cross or Blue Shield organization" as defined in § 833(c)(2). For valid business reasons, rather than conducting Government Business directly in each of the states and through Subsidiary in State 5, Parent will transfer the Government Business it conducts to separate Newcos that will operate exclusively in each of those states. In other words, Parent will "split up" Parent's Government Business by state and operate the Government Business through five wholly-owned subsidiaries. The Newcos will succeed to Parent's existing Government Business (and generate new business as part of conducting Government Business) using the capital received from Parent, Parent's employees, and the BCBS trademark and name. Furthermore, the business practices of each Newco will be consistent with Parent's past practices and will resemble those of Parent in all material respects.

Parent has no plan or intention to dispose of any of its shares in any of the Newcos to a third party and each Newco will join the Parent Consolidated Group. Restructuring Parent's business pursuant to the Proposed Transaction will not eliminate, reduce, or change any high-risk individuals or small group coverage, individually or in the aggregate. Accordingly, the Proposed Transaction will not extend the benefits of § 833(b) beyond those available to Parent currently.

RULINGS

Based on the facts presented and representations made, we conclude that pursuant to § 833(c)(2)(C), (1) the Proposed Transaction will not result in a material change in the operations or structure of Parent and (2) as a result of the Proposed Transaction, each Newco shall be treated as "an existing Blue Cross or Blue Shield organization."

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) of the Code 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,

Rebecca L. Baxter
Senior Technician Reviewer, Branch 4
(Financial Institutions & Products)

cc: