

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-139662-03, CC:FIP:4

District:LMSB:HMT:1135:RJP

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Company 1:
Company 2:

Newco:
Date 1:
Date 2:
Date 3:
Date 4:
Date 5:
Date 6:

ISSUE

Whether Newco, a corporation that acquires the assets of other Blue Cross/Blue Shield companies in transactions under section 368(a)(1)(A) of the Internal Revenue Code, must take into account the acquired Blue Cross/Blue Shields' adjusted surplus for purposes of determining Newco's section 833 deduction.

CONCLUSION

For purposes of determining Newco's section 833 deduction, Newco must combine the adjusted surplus of the acquired Blue Cross/Blue Shield companies for the first taxable year of Newco.

FACTS

Prior to 1987, Company 1 and Company 2 were exempt from Federal income taxation under section 501(c) (4) of the Code. Section 1012(a) of the Tax Reform Act of 1986 (TRA) added section 501(m), which provides that an organization described in sections 501(c)(3) or 501(c)(4) is exempt from Federal income taxation for taxable years beginning after December 31, 1986, only if no substantial part of its activities consist of providing commercial type insurance. Section 1012(b) of the TRA also added section 833, which provides, inter alia, that a Blue Cross or Blue Shield organization is taxed as a stock insurance company, but is allowed a special deduction under section 833(a)(2). In accord with sections 501(m) and 833, Company 1 and Company 2 each filed consolidated income tax returns as common parents of separate, consolidated groups, claiming the special deduction under section 833(a)(2) as warranted.

On Date 1, both Company 1 and Company 2 merged into a newly formed corporation, Newco, in tax-free re-organization transactions under section 368(a)(1)(A). The existence of both Company 1 and Company 2 terminated under state law. Transactions under section 368(a)(1)(A) are subject to the provisions of section 381 of the Code. Newco received rulings from the Internal Revenue Service that: (1) the continuity of interest requirement set forth in section 1.368-1(b) was satisfied, and (2) the consolidation of Company 1 and Company 2 into Newco will not be treated as a material change in operations or structure of Company 1 or Company 2 under section 833(c)(2)(C).

Newco claims that the Company 2 consolidated group survived pursuant to section 1.1502-75(d)(3) of the regulations and Rev. Rul. 89-80, 1989-1 C.B. 273. As a result, after the consolidation in which Company 1 and Company 2 merged into Newco, the Company 1 group filed a final consolidated return for the short tax-year Date 3. The Company 2 group, filing with Newco as the new common parent, filed a return for the tax year ending Date 4, including Company 1 for the period Date 5. In the return filed for the period ending Date 4, no deduction under section 833(a)(2) was claimed. Newco presumes that the deduction under section 833(a)(2) was not available due to a loss reported for Date 5. For the tax years ending Date 6, Newco calculated its section 833 deduction by taking into account the "adjusted surplus" for Company 1 and Company 2. Subsequently, Newco amended its returns claiming that Newco should have only included Company 2's adjusted surplus in Newco's adjusted surplus.

LAW AND ANALYSIS

Section 833(a) of the Code 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 section 833, an organization must be an “existing Blue Cross or Blue Shield organization” as defined in section 833(c)(2) or an organization described in section 833(c)(3).

Section 833(c)(2) defines the phrase “existing Blue Cross or Blue Shield organization” as any Blue Cross or Blue Shield organization in existence as of August 16, 1986, which was tax exempt for its last taxable year beginning before January 1, 1987, and which did not undergo any material change in operation or structure after August 16, 1986. Further, to the extent permitted by the Secretary, any Blue Cross/ Blue Shield organization resulting from the merger or consolidation of organizations, each of which met the requirements of section 833(c)(2), is treated as an “existing Blue Cross or Blue Shield organization” for purposes of section 833.

Section 833(a)(2) provides that the deduction (known as the special deduction) determined under section 833(b) for any taxable year shall be allowed.

Section 833(b)(1) establishes the amount of deduction as the excess (if any) of-

- (A) 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) the expenses incurred during the taxable year in connection with the administration, adjustment, or settlement of claims or in connection with the administration of cost-plus contracts, over
- (B) the adjusted surplus as of the beginning of the taxable year.

Section 833(b)(2) limits the special deduction for any taxable year to an amount that does not exceed taxable income for the taxable year (determined without regard to the special deduction).

Section 833(b) defines the term “adjusted surplus” as the surplus as of January 1, 1987 on the insurance company’s annual statement adjusted each succeeding year for adjusted taxable income and adjusted net operating loss.

Specifically, section 833(b)(3) provides that the adjusted surplus is determined as follows:

- (A) The adjusted surplus as of the beginning of any taxable year is an amount equal to the adjusted surplus as of the beginning of the preceding taxable year-
 - (i) increased by the amount of any adjusted taxable income for such preceding taxable year; or
 - (ii) decreased by the amount of any adjusted net operating loss for such preceding taxable year.

- (B) The adjusted surplus as of the beginning of the organization's first taxable year beginning after December 31, 1986, shall be its surplus as of such time. For purposes of the preceding sentence and subsection (c)(3)(C), the term "surplus" means the excess of the total assets over the total liabilities as shown on the annual statement.

- (C) The term "adjusted taxable income" means taxable income determined-
 - a. without regard to the deduction determined under this subsection,
 - b. without regard to any carryforward or carryback to such taxable year, and
 - c. by increasing gross income by an amount equal to the net exempt income for the taxable year.

- (D) The term "adjusted net operating loss" means the net operating loss for any taxable year determined with the adjustments set forth in subparagraph (C).

Both Company 1 and Company 2 qualify under section 833(c)(2) as existing Blue Cross or Blue Shield organizations. They were both in existence as of August 16, 1986; they were both tax exempt for their last taxable years beginning before January 1, 1987; and neither underwent any material change in operation or structure after August 16, 1986. Newco represents that Company 1 was terminated at the time of the consolidation. Newco claims that there are no provisions in section 833 that require Newco to combine the adjusted surplus of Company 1 and Company 2 to arrive at adjusted surplus for Newco.

For purposes of a merger or consolidation, section 833(c) indicates that any organization resulting from a merger or consolidation is treated as an existing Blue Cross/Blue Shield organization. Newco qualifies as such an organization. In a merger or consolidation the assets and liabilities are amalgamated. Newco had no adjusted surplus generated on its own as of January 1, 1987 (when the Blue Cross/ Blue Shield companies became taxable) or Date 1 (the date of merger). Company 1 and 2 had

adjusted surplus at January 1, 1987 and each succeeding year right up to the merger or consolidation. Newco is the sum of its parts and each part had adjusted surplus. Newco must compute adjusted surplus as if it was Company 1 and Company 2 as of January 1, 1987. Thus, to determine the correct adjusted surplus of Newco, Newco must combine the adjusted surplus generated by Company 1 and Company 2 as of the first day of Newco's first taxable year.

Because Company 1 and Company 2 each qualified as an existing Blue Cross or Blue Shield organization, they each had adjusted surplus as defined in section 833(b)(3) as of Date 2. In order to derive the adjusted surplus for Newco, Newco must amalgamate the adjusted surplus for both Company 1 and Company 2. However, Newco contends that as a result of the termination of Company, only the adjusted surplus of Company 2 is carried over to Newco. Newco contends that the flush language of section 833(c)(2) refers to "an" organization thus providing that Company 2 is the surviving entity. Section 833(c) provides rules for organizations to which section 833 applies. The argument that the article "an" indicates Congress' intent to redefine "adjusted surplus" as set forth in a previous paragraph (section 833(b)) is misplaced. The critical element in section 833 is that the two organizations were in existence on August 16, 1986, were exempt from tax for their last taxable year beginning before January 1, 1987, and that no material change occurred in the operation or structure after August 16, 1986, and before the close of the taxable year in which they were combined. The language "an existing Blue Cross or Blue Shield organization" in section 833(c)(2) is only part of a rule whose sole purpose is to grant section 833 treatment to a reorganized taxpayer. The language is part of a provision recognizing that the reorganized entity is an amalgamation of its parts.

The special deduction allowed to existing Blue Cross or Blue Shield organizations is one based on claims less adjusted surplus. Both Company 1 and Company 2 had claims and adjusted surplus prior to the reorganization. Newco must follow consistent treatment after the reorganization. Newco can not determine the special deduction with claims from Company 1 and Company 2 less the adjusted surplus of only Company 2.

Section 833(c)(3) specifically addresses "other organizations" – those that are not existing Blue Cross or Blue Shield organizations but that under special circumstances will qualify to be treated as if they were for any particular year. Section 833(c)(3)(C) provides that as of the beginning of the 1st taxable year for which it meets the requirements of section 833(c)(3), the adjusted surplus is its surplus as of such time. This rule is consistent with section 833(c)(2) which requires the existing Blue Cross/Blue Shield organizations start with the adjusted surplus as of the beginning of the organization's first taxable year beginning after December 31, 1986. If Newco is considered to be an existing Blue Cross/ Blue Shield, then the provisions of section

833(c)(2) apply to Newco. Accordingly, to determine Newco's adjusted surplus under these provisions, the adjusted surplus of Company 1 and Company 2 must be combined.

Combining the adjusted surplus of Company 1 and Company 2 is also consistent with section 381(c)(22) of the Code. Section 381(c)(22) specifies the tax items required to be taken into account where the acquiring corporation, such as Newco, is a successor insurance company subject to tax under Subchapter L of Chapter 1 of Subtitle A. Section 381(c)(22) provides that:

If the acquiring corporation is an insurance company taxable under subchapter L, there shall be taken into account (to the extent proper to carry out the purposes of this section and of subchapter L, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of subchapter L in respect of the distributor or transferor corporation.

In determining insurance company income, companies under the provisions of section 833, are permitted a deduction from their insurance company income. Congress, however, intended to exempt only enough taxable income each year to allow a Blue Cross or Blue Shield organization to maintain reserves equal to 25 percent of the tax year's health-related payouts. See S. Rpt. 102-119, 102d Cong. 2d Sess. 184 (1992). In order to ensure that only the appropriate level of reserves is maintained, section 833(a)(2) requires a comparison of health-related payouts against beginning adjusted surplus. Thus, it is apparent that the adjusted surplus is one of the basic elements of the special deduction computation.

The inclusion of adjusted surplus as an item to be taken into account for purposes of subchapter L is consistent with the legislative history underlying section 381. The legislative history explains that the purpose of section 381 was to put into practice the policy that "economic realities rather than ... such artificialities as the legal form of the reorganization" ought to control whether a tax attribute from an acquired corporation is to be carried over to the acquiring corporation. Tax results of the liquidations or reorganizations are to "depend less upon the form of the transaction than upon the economic integration of two or more separate businesses into a unified business enterprise". S. Rep. No. 1622, 52, 83rd Cong., 2d Sess. (1954).

In order to recognize the economic reality - that the Blue Cross/Blue Shield continues in operation without a material change, the adjusted surplus of both Company 1 and Company 2 must be combined for the first taxable year of Newco because Newco had no adjusted surplus at Date 1.

CAVEAT

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.