

Office of Chief Counsel  
Internal Revenue Service

# Memorandum

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to: LB&I Heavy Manufacturing & Pharmaceuticals

from: Associate Area Counsel, Boston

CC:LB&I:F:BOS1

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subject:

Taxable years and

This refers to a request by Revenue Agent \_\_\_\_\_ for advice regarding claims by the above-named Taxpayer that certain subsidiaries of Taxpayer qualify for taxation as "other organizations" under I.R.C. § 833(c)(3).

## LEGEND

TAXPAYER PARENT =

TAXPAYER =

SECOND TIER SUB =

HEALTH SUB 1 =

HEALTH SUB 2 =

HEALTH SUB 3 =

## ISSUES

1. Is the special tax treatment provided for "other organizations" as described in I.R.C. § 833(c)(3)(A), limited to organizations that were in existence on the effective date of that section, or does it apply to organizations that come into existence after that date?

2. If section 833 does apply to organizations that come into existence after the effective date of the statute:
  - a. Subsection 833(c)(3)(A)(ii) requires that at least 10 percent of the health insurance provided by such organization must be provided to individuals and small groups (not taking into account any medicare supplemental coverage). Does this test include all individuals receiving health care benefits through the organization, or does it exclude individuals receiving benefits under certain government programs that are administered by the organization?
  - b. Subsection 833(c)(3)(A)(v) requires that at least 35 percent of the organization's premiums must be determined on a community rated basis. Does this test include all individuals receiving health care benefits through the organization, or does it exclude individuals receiving benefits under certain government programs that are administered by the organization?
3. If the percentage tests under subsections 833(c)(A)(ii) and (v) do include individuals receiving benefits under certain government programs, does the requirement under subsection 833(c)(3)(A)(v) that premiums must be determined on a "community rated basis" refer to pure community rating, or does it include "adjusted" community rating or community rating "by class"?

**CONCLUSIONS:** Section 833(c)(3) applies to organizations that come into existence after the effective date of the statute. Assuming that Taxpayer is eligible for the special tax treatment provided by section 833, we believe that the tests for qualifying under section 833 do not include coverages under certain government programs. Furthermore, regardless of whether certain government programs are includible in the qualifying tests, we conclude that Taxpayer does not satisfy the community rating test under section 833(c)(3)(A)(v).

## STATEMENT OF FACTS

**General Information.** Taxpayer claims that three of its subsidiaries qualify as "other organizations" entitled to the special tax treatment provided in I.R.C. § 833. The statute will be analyzed further below, but in order to put the facts in context, section 833(c)(3)(A) requires:

(3) Other Organizations -- (A) In General-- An organization meets the requirements of this paragraph for any taxable year if --

(i) substantially all the activities of such organization involve the providing of health insurance,

(ii) at least 10 percent of the health insurance provided by such organization is provided to individuals and small groups (not taking into account any medicare supplemental coverage),

(iii) such organization provides continuous full-year open enrollment (including conversions) for individuals and small groups,

(iv) such organization's policies covering individuals provide full coverage of preexisting conditions of high-risk individuals without a price differential (with a reasonable waiting period), and coverage is provided without regard to age, income, or employment status of individuals under age 65,

(v) at least 35 percent of its premiums are determined on a community rated basis, and

(vi) no part of its net earnings inures to the benefit of any private shareholder or individual.

The issues under consideration were first raised by Taxpayer

. If in fact the subsidiaries qualify for taxation under section 833, they would be allowed to claim "special deductions" as provided under section 833(a)(2). These special deductions would reduce the absorption of net operating losses in earlier periods, with the result that the NOLs could be carried forward to later periods. The total increase in the carryforwards is approximately \$

The following description of Taxpayer's structure and activities is based on the

Taxpayer is a wholly-owned subsidiary of TAXPAYER PARENT, which is exempt from federal income tax under section 501(c)(3) of the Code.

Taxpayer's second tier, for-profit and wholly-owned subsidiary, SECOND TIER SUB, controls 100 percent of the outstanding stock of several domestic corporations taxed as nonlife insurance companies under section 831 of the Code, which include HEALTH SUB 2, and HEALTH SUB 3. SECOND TIER SUB also controls \_\_\_\_\_ percent of the ownership interests of HEALTH SUB 1, which is organized as a nonprofit, nonstock corporation under state law. HEALTH SUB 2, HEALTH SUB 3, and HEALTH SUB 1 (collectively, "TAXPAYER Health Insurers"), are the entities that are under consideration regarding the application of section 833.

HEALTH SUB 2, HEALTH SUB 3, and HEALTH SUB 1, along with SECOND TIER SUB, four other wholly-owned domestic corporations also taxed as nonlife insurance companies, and several other noninsurance corporations, join with Taxpayer (collectively, "Parent Group") in filing a consolidated federal income tax return on Form 1120. The Parent Group reports on a fiscal year . Each of the TAXPAYER Health Insurers has consistently reported its taxable income as part of the Parent Group for every tax year that each of the TAXPAYER Health Insurers has conducted its business operations. According to Taxpayer, all activities of the TAXPAYER Health Insurers are related to the providing of health insurance.

### HEALTH SUB 1

### HEALTH SUB 2

### HEALTH SUB 3

**Qualification for I.R.C. § 833.** In support of its claim that HEALTH SUB 2, HEALTH SUB 3, and HEALTH SUB 1 qualify for taxation as "other organizations" under I.R.C. § 833(c)(3) Taxpayer submitted

At the present time it does not appear that there is any dispute that each of these three entities satisfy the first test (substantially all the activities of such organization involve the providing of health insurance); the third test (open enrollment for individuals and small groups); the fourth test (coverage of preexisting conditions of high-risk individuals, and coverage without regard to age, income, or employment status of individuals under age 65); and the sixth test (no inurement). The issues in dispute regard the applicability of section 833 to organizations that were not in existence at the date the statute took effect, and whether Taxpayer satisfies the second and fifth tests, which require that at least 10 percent of the health insurance provided by such organization is provided to individuals and small groups, and that at least 35 percent of its premiums are determined on a community rated basis. These two tests raise issues whether coverage under certain government programs may be considered at all, and whether such coverages satisfy the "community rating" requirement of section 833.

The schedules show categories based on types of coverage, without specific descriptions of the coverages, and then makes conclusory interpretations of those coverages.

**HEALTH SUB 1.** For purposes of the 10% test, for early years it appears that Taxpayer is relying on coverage for  
In later years, the computations appear to rely on coverages for

For purposes of the 35% test, it appears that Taxpayer is relying on the same coverages, with the difference that the numbers for the 10% test limit the small group items to groups of 2-15 as required by section 833, while the numbers for the 35% test include small groups of up to 50 members.

**HEALTH SUB 2.** For purposes of the 10% test, it appears that items are being included for

For purposes of the 35% test, it appears that Taxpayer is relying on the same coverages up through , with the difference in the numbers for small groups. For through , it appears Taxpayer is including

For through as Taxpayer asserts that 100% of its total enrollment is community rated, which is inconsistent with its determinations for HEALTH SUB 1 and HEALTH SUB 3. In addition, the totals for the columns are incorrect. The columns include significant amounts for but these numbers are not included in the totals.

**HEALTH SUB 3.** For purposes of the 10% test, it appears that items are being included

For purposes of the 35% test, it appears that Taxpayer is relying on the same coverages, with the difference in the numbers for small groups.

### **Background on Blue Cross and Blue Shield (BCBS), Health Maintenance Organizations (HMOs), and Community Rating**

Health care services in the United States are provided and financed through a variety of organizations which in turn reflect different approaches to health care.

- some entities are providers of services, such as hospitals and doctors;
- some entities finance services, such as employers and insurance companies;
- and some entities combine both functions in different ways, such as Blue Cross and Blue Shield organizations, and Health Maintenance Organizations.

Because all these entities are directed at the common problems of providing and financing health care, there are similarities in their operations. Strategies or