INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

March 16, 2005

Number: **200528026**

Release Date: 7/15/2005

Third Party Communication: None

Date of Communication: Not Applicable

Index (UIL) No.: 833.03-01, 833.03-03
CASE-MIS No.: TAM-158043-04

Taxpayer's Name:
Taxpayer's Address:

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

LEGEND:

Taxpayer:

Parent:

Corp. A:

Sub. A:

Sub. B:

Sub. C:

Entity A:

State A:

Plan(s):

Organization:

Year A:

Year B:

Year C:

Date A:

Date B:

Date C:

Date D:

Date E:

Date F:

Date G:

Date H:

Date I:

Date J:

Date K:

Date L:

Date M:

Date N:

Section 1:

Section 2:

Section 3:

Number A:

Number B:

Number C:

Number D:

Number E:

Number F:

Number G:

Number H:

Number I:

Number J:

Number K:

Number L:

Number M:

Number N:

Number O:

Number P:

Name A:

Name B:

Name C:

ISSUE(S):

1. Whether Taxpayer's amendments to its articles of incorporation in Year A to convert to a for-profit stock entity or the issuance of stock in Year B constituted a material change in operations or a material change in structure under § 833(c)(2)(C) of the Internal Revenue Code.
2. If there is a material change in operations or in structure, did it occur in Year A or in Year B.
3. Are the § 833 benefits lost for the entire calendar year in which a material change has occurred.
4. May the benefits of § 1012 of the Tax Reform Act of 1986, Public Law 99-514 (October 22, 1986), be claimed after a material change in operations or in structure.

CONCLUSION(S):

1. Taxpayer's issuance of stock after its conversion to a for-profit stock entity in Year B constituted a material change in structure under § 833(c)(2).
2. The material change occurred in Year B.
3. The § 833 benefits are lost for the entire calendar year in which a material change has occurred.
4. The benefits of §1012 of the Tax Reform Act of 1986 may not be claimed after a material change in operations or in structure.

FACTS:

Taxpayer is a for-profit stock corporation that provides health insurance in State A. Taxpayer is a successor by merger of several Plans operating in State A. Taxpayer is a licensee of the Organization, which permits taxpayer, subject to compliance with Organization's regulation, to use exclusively, the Plan name, trademarks, and service marks in State A.

Taxpayer's articles of incorporation, as of Date A, provided that it was established as a nonprofit health care corporation for the purpose of operating and maintaining one or more health care plans as defined in Section 1 of the Official Code of State A Annotated. Taxpayer was a nonmember corporation with its operations and affairs governed by a board of directors in accordance with state statutory requirements under Section 2. Taxpayer's articles of incorporation specifically stated that it was organized exclusively for charitable purposes and that no part of its net earnings could be used for the benefit of any individual or entity. Further, Taxpayer's articles of incorporation stated that upon liquidation, all of its net assets would be distributed to one or more organizations described in § 501(c)(3) of the Code. Effective Date B, Taxpayer amended its articles of incorporation to eliminate all references to charitable purposes.

This change in the articles of incorporation was part of a plan to convert Taxpayer from being a nonprofit non-stock corporation to a for-profit stock corporation so that it could be more competitive with out of state health insurers that were entering State A's health insurance market. It would be able to raise a large amount of capital that would result in enhanced financial resources. In addition, two years prior to the amending of its article of incorporation, the Organization changed its long standing requirement that all Plans must be organized as nonprofit corporations and, therefore, allowed Plans to convert to for-profit corporations.

In order to implement Taxpayer's plan of conversion to a for-profit stock corporation, it was necessary that the State A legislature enacted several amendments to its Code. One amendment provided that all nonprofit corporations, except for certain nonprofit "charitable corporations", may convert to for-profit status by amending their articles of incorporation to operate as a for-profit corporation. Another amendment provided that no reserved funds of a nonprofit health care corporation shall be distributed or paid to any person as a part of any plan of conversion of a nonprofit health care corporation to a for-profit health care corporation.

On Date C, Taxpayer filed a plan of conversion with the Insurance Department of State A requesting approval of Taxpayer's conversion from a nonprofit non-stock corporation to a business corporation under the Code of State A. The following steps were to be taken under the plan of conversion: (1) Taxpayer was to incorporate Corp. A and cause Corp. A to issue Number A shares of stock in exchange for $ Number B, (2) Taxpayer was to amend its articles of incorporation under Section 3 of the Code of State A, (3) Taxpayer was to issue Number B of its common stock (which is 100% of its common stock) to Corp. A, and (4) Corp. A was to issue preferred stock (the same class issued by Corp. A to Taxpayer in step (1)) to unrelated private investors in exchange for cash and to issue Class A common stock to an escrow agent for distribution to Eligible Subscribers as defined below.

Following a hearing on Date D, the Insurance Commissioner of State A, by "Order" approved on Date E the proposed conversion to for-profit status and the acquisition by Corp. A of Taxpayer. Following this a "Certificate of restated Articles of Incorporation" was certified by the Secretary of State of State A for Taxpayer. On Date F, the Insurance Commissioner of State A approved the amended articles of incorporation.

The amended articles of incorporation dated Date G include the following provisions. The corporation would cease to operate as a nonprofit corporation and thereafter operate as a business corporation governed by the State A Business Corporation Code. All of the operations and affairs of the corporation would be controlled by the board of directors elected in accordance with the by-laws. Each director of Taxpayer is a director of Corp. A. Taxpayer shall have the authority to issue Number B shares of common stock with a par value of $ Number A a share.

On Date H, Corp. A was officially formed as a new corporation in State A. It was organized for the purpose of acting as a holding company for Taxpayer and its subsidiaries, its only business is their ownership and operation. It was organized by Taxpayer, which paid $ Number B cash for Number A share of Corp. A's convertible preferred stock. Then, Taxpayer issued 100% of its common stock (Number B shares) to, and became a wholly-owned subsidiary, of Corp. A. At the same time Corp. A issued Number C shares of preferred stock to selected preferred shareholders for $ Number B per share. The net proceeds from the sale of the preferred stock were approximately $ Number D, after deducting estimated offering expenses and certain other expenses of the conversion. One individual, Name A through ownership of Name B, owned Number E shares (92% of the total).

The preferred stockholders held 90% of the voting rights of the board of Corp. A (and thus Taxpayer) after the conversion. They were entitled to receive dividends of $ Number F/year per share on and prior to Date I, and $ Number G/year per share after Date I. Dividends were payable in cash annually in arrears due Date J of each year beginning Date K.

In addition to the preferred stock, Corp. A also issued Number H shares of Class A stock to Name C as its escrow agent, for distribution to "eligible subscribers" (policyholders) of Taxpayer. An "eligible subscriber" under the State A Insurance Code was a subscriber (policyholder) of Taxpayer on Date L and who remained a subscriber on Date M. Each eligible subscriber, out of approximately Number I, was offered Number J of Class A stock at no cost. Under State A's Insurance Code, Taxpayer was obligated to offer shares in connection with an initial public offering to its subscribers on similar terms as such share are offered to the public. The State A Insurance Commissioner held that this offer of shares to eligible subscribers extinguished such rights of the subscribers. Originally, there were Number K subscribers who accepted Number L shares of no par value Class A Stock. Corp. A's registration of its Class A stock with the Securities and Exchange Commission was effective Date N. The Class A stockholders were entitled to vote on Number M of the Number N Directors of Corp. A. However, the total number was to be gradually voted in over a period three years, with the first year allowing Class A to vote on Number O of Number M, the second year, another Number O, and the third year and thereafter for a total of Number M. They were not entitled to receive dividends as long as any preferred stock was issued and outstanding.

On the date of the conversion and immediately thereafter, Taxpayer owned all the stock of Sub. A, Sub. B, Sub. C, and part of the stock of Entity A. A few years later, Corp. A and Taxpayer were acquired by Parent.

LAW AND ANALYSIS:

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 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 Tax Reform Act of 1986 (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.

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 meeting the requirements of § 833(c)(3). 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) the organization is determined to be exempt from tax for its last taxable year beginning before January 1, 1987, and (3) 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 the 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 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.

As previously noted, § 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. In Year C, 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. This process involved several stages. Basically, the first stage was enactment of state laws that changed the classification of the entity and its assets. During this process, questions were raised primarily that focused on prior classification of the entity as nonprofit. Because Taxpayer was a unique entity when it was established, it was subject to state laws that were tailored to the way it operated. Because it was in existence for such a long period of time, not many questions were raised about its operation as a nonprofit entity until the conversion process was started. Generally, under state law the state attorney general has oversight in the operation of nonprofit entities. This oversight includes the disposition of the assets of such an entity. Because Taxpayer had significant assets at the time of the conversion, issues were raised as to the operation and control of Taxpayer. One of the first pieces of legislation that was enacted in this process was to remove the requirement that the assets of Taxpayer, if disposed of, had to go to a charitable entity. Other legislation was passed that allowed Taxpayer to conform to the general business statutes under which for profit corporations operate under in State A.

There are two primary sources of state control over conversions: nonprofit conversion law and statutory and common law principles governing protection of charitable assets. Conversions to for-profit status generally involves two aspects of nonprofit corporation law: fiduciary obligations imposed on directors in making and entering the conversion decision, and if required under the particular statute at issue, notification requirements to the state attorney general on the sale of corporate assets or change in the fundamental nature of the corporation. Nonprofit corporation law demands that the directors of a nonprofit corporation serve the corporation with undivided loyalty and due care. The duty of loyalty requires board members to place the interests of the corporation before their own interest, and thus prohibits earning secret profit from corporate activities, competing with the corporation, or otherwise jeopardizing corporate activities. The duty of loyalty is designed to insure that only pure motivations drive business decisions, the duty of care is intended to encourage wise decision making. Decision making by nonprofit directors is also protected by the business judgment rule. Under this rule, the business judgment of directors may not be challenged or overturned, and directors will not be held liable for the consequences of their decisions, so long as the decisions were made in an informed manner and in good faith. Further protection is afforded to directors of nonprofit corporations in that only a limited number of parties can challenge board action. In all states, the attorney general is empowered to police the use of charitable assets, although in some cases the authority granted the attorney general is limited. <u>See,</u> Lawrence Singer, <u>The Conversion Conundrum: The State and Federal Response to Hospitals' Changes in</u>

Charitable Status, 23 Am. L.J. and Med. 221 (1997), and Philip P. Bisesi, Conversion of Nonprofit Health Care Entities to For-Profit Status, 26 Cap. U.L. Rev. 805 (1997).

While corporate law fiduciary principles govern the actions of nonprofit directors, charitable trust law governs the assets of nonprofit, tax exempt entities. However, in the case where the entity does not receive its assets as a result of charitable donations, application of some of the charitable trust law is more questionable. Charitable trust law does not prohibit the sale of corporate assets so long as the sale is not specifically prohibited in the donor's grant. Generally, the practical thrust of the trust law has been to require upon conversion, assets of equal value to those converted be irrevocably dedicated to charitable purposes. Typically, this is accomplished through the formation of a foundation. However, in Taxpayer's case this was not required.

When § 833 was enacted, it was intended to apply to a specific group of Taxpayers that lost their tax exempt status under § 501(m). It is agreed that Taxpayer qualified as an existing Blue Cross or Blue Shield organization under § 833(c)(2) for taxable years prior Year A. Neither the Code nor the legislative history of §§ 833 and 501(m) (there are no regulations), explain in any detail as to who were existing Blue Cross or Blue Shield organizations. It was known at the time these provisions were enacted as to who the entities were that were subject to this provision. It must have been assumed that an entity that was allowed to use the name and marks of the Organization was licensed to do so at the time § 833 was enacted. This would mean that licensing was an initial requirement of § 833. One of the licensing requirements of the Organization was that the entity be nonprofit under state law. This long standing requirement was dropped by the Organization in Year C which was several years after the enactment of § 833. Also, when § 833 was enacted, at least Number P entities that were existing Blue Cross or Blue Shield organizations were structured under state law as nonprofit mutual organizations.

The first issue is whether Taxpayer's amendment to its articles on incorporation in Year A to convert to a for-profit stock entity or the issuance of stock in Year B constitutes a material change in the operations of such organization or in its structure under § 833(c)(2)(C). The second issue is if there is a material change, did it occur in Year A or in Year B.

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 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 stock against the test of material change in structure.

Taxpayer's conversion from being a nonprofit non-stock entity to being a for-profit stock entity involved not only changing Taxpayer's articles of incorporation but also a change in how this corporation is governed under state law. It involved state law being change to facilitate the conversion. It resulted in significant changes in fiduciary responsibility of the directors. The issuance of stock (both common and preferred) clearly created rights and also responsibilities that Taxpayer was not previously subject to as a non-stock non profit entity. The duty to pay the preferred stockholders stated dividends created a corporate obligation that it previously was not subject to by law. The conversion changed the taxpayer's relationship to other individuals or entities. Previously, Taxpayer had customers and a somewhat unclear ownership group, possibly a broad or vague charitable group, but only for purposes of dissolution. Taxpayer was a nonprofit entity. Upon conversion and issuance of stock, Taxpayer now has a new relationship with owners of its stock who are concerned with profits. These new owners do not have to be customers. There is a fundamental difference between a nonprofit non-stock entity and a for-profit stock entity. 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.

Because there was a material change in structure under § 833(c)(2), the second issue is whether this material change occurred in Year A when Taxpayer amended its articles of incorporation to convert to a for-profit entity or in Year B when Taxpayer actually issued stock as a for-profit entity. The conversion to a for-profit entity may be viewed as a material change under the statute. On the other hand, the sale of stock 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. The material change in structure occurred in Year B when Taxpayer, in effect, completed conversion to a for-profit stock entity and issued stock.

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 nonprofit organizations.

The third issue is whether the § 833 benefits are lost for the entire calendar year in which a material change has occurred. 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, the determination point is the end of the year for the entire year. Section 833 has a number of other references to "taxable 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.

The fourth issue is whether the benefits of § 1012(c)(3)(A)(ii) of the Act can be claimed by an entity that is no longer an existing Blue Cross or Blue Shield organization under § 833(c)(2) of the Code. 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 under § 833(c)(2) can not claim the benefits of § 1012(c)(3)(A)(ii).

CAVEAT(S):

Temporary or final regulations pertaining to one or more of the issues addressed in this memorandum have not yet been adopted. Therefore, this memorandum will be modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusion in the memorandum. See section 15.04 of Rev. Proc. 2005-2, 2005-1 I.R.B. 86, 112 (or any successor). However, a technical advice memorandum that modifies or revokes a letter ruling or another technical advice memorandum generally is not applied retroactively if the taxpayer can demonstrate that the criteria in section 15.06 of Rev. Proc. 2005-2, are satisfied.

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.