BEFORE THE INSURANCE DEPARTMENT
OF THE
COMMONWEALTH OF PENNSYLVANIA

Statement Regarding the Acquisition of Control of or Merger with Domestic Insurers:

Hospital Service Association of Northeastern Pennsylvania
d/b/a Blue Cross of Northeastern Pennsylvania;
First Priority Life Insurance Company, Inc.;
HMO of Northeastern Pennsylvania, Inc.,
d/b/a First Priority Health

By Highmark Inc.

HIGHMARK INC. ("Highmark") RESPONSE TO SUPPLEMENTAL INFORMATION REQUEST 5.3.14 FROM THE PENNSYLVANIA INSURANCE DEPARTMENT

SUPPLEMENTAL REQUEST 5.3.14 (via letter from PID dated August 27, 2014)

Required Action: Please provide an analysis, including reference to legal authority as to how the Transaction will qualify as a tax free reorganization under IRC § 368, and identify the provisions of the Merger Agreement or other Documents supporting that analysis.

RESPONSE:

Highmark hereby supplements its prior response to this Request as follows:

Highmark certifies to the best of its knowledge, information and belief as follows:

The Transaction constitutes a statutory merger under Internal Revenue Code Section 368(a)(1)(A). Following the merger, Highmark has agreed, pursuant to Section 6.3 of the Merger Agreement, to operate the Acquired Business in a manner that is consistent with the historic corporate mission of BCNEPA to provide health services and products to improve the quality, accessibility and affordability of health care in the BCNEPA service area. Therefore, the merger will meet the continuity of business enterprise standards required by Treasury Regulation § 1.368-1. Additionally, BCNEPA will have the ability to designate, subject to the approval of Highmark Health, 4 Class A Directors to Highmark's Board of Directors and Highmark will continue to serve the populations that BCNEPA previously served. Therefore, the merger will meet the continuity of interest standards required by Treasury Regulation § 1.368-1. As a statutory merger that meets the continuity of business enterprise and continuity of interest tests, the merger of Highmark and BCNEPA qualifies as a tax-free reorganization.

As indicated, Highmark has not obtained a written tax opinion or analysis of the tax issues concerning the Transaction. Neither a written tax opinion nor analysis of the tax issues will be sought because the Transaction is nearly identical to the 1996 statutory merger between Pennsylvania Blue Shield and Blue Cross of Western Pennsylvania to form Highmark. There, the Internal Revenue Service was made aware of the statutory merger of the two nonprofit organizations and issued a private letter ruling that the continuity requirements were met. The transaction ultimately qualified as a tax-free reorganization. Highmark believes that the merger of Highmark and BCNEPA will be afforded the same treatment.

Attached hereto is a copy of the above referenced private letter ruling.

Highmark Inc.
Fifth Avenue Place
120 Fifth Avenue
Pittsburgh, PA 15222

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Private Letter Rulings

Private Letter Ruling 9720016, 5/16/1997, IRC Sec(s). 833;368

UIL No. 0368.08-00

Headnote:

Reference(s): Code Sec. 833; ;Code Sec. 368;

The Service has ruled that the merger of two nonprofit, nonstock insurance companies into a new company will satisfy continuity requirements and will not be a material change under section 833(c)(2).

Full Text:

Date: February 6, 1997

Refer Reply to: CC:DOM:CORP:2 PLR-52560-96

LEGEND:

Target 1 = ***

Target 2 = ***

State = ***

X = ***

Y = ***

Dear ***

This is in reply to a letter dated February 26, 1996, in which rulings were requested regarding the federal income tax consequences of a proposed transaction. Specifically, rulings were requested concerning the consolidation of Target 1 and Target 2. Additional information was received in letters dated September 3, 1996 and October 2, 1996. In a letter dated January 24, 1997, you withdrew requested ruling #3.

Target 1 is a State nonprofit, nonstock, insurance company and common parent of a group filing a consolidated return using a calendar year accounting period. Target 1 has 300 “members” who elect the board of Directors. Target 1 has 31 members on its Board of Directors. All directors must be members.

Target 2 is a State nonprofit, nonstock, insurance company and common parent of a group filing a consolidated return using a calendar year accounting period. Target 2 has 20 “members” on its board of directors. The board of directors elects new directors.

Under State law, none of the profits of Target 1 or Target 2 shall be divided or distributed to the corporation's members, directors or officers. The liquidation of Target 1 or Target 2 would have to be approved by the State insurance department. Policyholders have no voting rights as policyholders.

Target 1 and Target 2 have represented that there is a valid business purpose for the following transactions. In accordance with State law, Target 1 and Target 2 will merge into a new corporation, Newco. The separate existence of Target 1 and Target 2 shall cease and all assets and liabilities will be deemed transferred and vested in Newco. No officer, director, member, or policyholder will receive anything, including cash, as part of these transactions.

Newco's bylaws provide that it will have 156 individual corporate members (Members). The Members will have the right to elect or remove Members and directors. One quarter of the Members will be doctors and three-quarters will be customers. Prior to the consolidation, Target 1 and Target 2 shall each appoint 78 individuals to serve as members of Newco. Target 2 shall consider appointing existing Target 1 Members as Members of Newco but is under no obligation. Approximately 70 percent shall be lay members and the remaining 30 percent shall be professional members. Target 1 and Target 2 will each appoint 18 of the initial 36 Newco directors. The Members will elect Newco's board of directors subsequently.

The following additional representations have been submitted concerning the transactions:

(a) The fair market value of the proprietary interest in Newco and other consideration received pursuant to the consolidation will be approximately equal to the fair market value of the Target 1 and Target 2 proprietary interest surrendered in the exchange.

(b) Newco has no plan or intention to reacquire any of its proprietary interests issued in the transaction.

(c) Newco has no plan or intention to sell or otherwise dispose of any of the assets of Target 1 or Target 2 acquired in the transaction, except for dispositions made in the ordinary course of business or transfers described in section 368(a)(2)(C) of the Internal Revenue Code.

(d) The liabilities of Target 1 and Target 2 assumed, as a result of the consolidation by Newco and the liabilities to which the transferred assets of Target 1 and Target 2 are subject were incurred by Target 1 and Target 2 in the ordinary course of its business.

(e) Following the transaction, Newco will continue the historic business of Target 1 and Target 2, using a significant portion of Target 1's and Target 2's historic business assets in the business.

(f) Newco, Target 1 and Target 2, will pay their respective expenses, if any, incurred in connection with the transaction.

(g) There is no intercorporate indebtedness existing between Target 1, Target 2, and Newco that was issued, acquired, or will be settled at a discount.

(h) No parties to the transaction are investment companies as defined in section 368(a)(2)(F)(iii) and (iv) of the Code.

(i) Target 1 and Target 2 are not under the jurisdiction of a court in a Title 11 or similar case or proceeding within the meaning of section 368(a)(3)(A) of the Code.

(j) The fair market value of the assets of Target 1 and Target 2 transferred to Newco in each instance will equal or exceed the sum of the liabilities assumed, as a result of the consolidation, by Newco plus the amount of liabilities, if any, to which the transferred assets are subject.

(k) Neither Target 1 nor Target 2 has experienced a material change in operations or structure, as descried in the legislative history of section 833 of the Code, since August l6, 1986.

(l) Target 1 and Target 2 expect to remain not-for-profit entities and have no current plans to legally change to for profit status.

Section 1.368-1(b) of the Income Tax Regulations provides, generally, that requisite to a reorganization under the Code is a continuity of interest therein on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization. The requirement is intended to distinguish sales which technically satisfied the reorganization provisions from being tax-free exchanges by requiring the owners of the target corporation to receive and retain an equity interest in the acquiring corporation.

Where traditional equity interests do not exist, the courts and the Service have used one of the indicia of ownership to identify the equity owners of corporations for purposes of determining whether continuity is satisfied. The indicia of an equity interest are: the right to vote, the right to a pro rata distribution of earnings and surplus, and the right to share in liquidation proceeds. Paulsen v. CIR, 469 U.S. 131 (1985); Rev. Rul. 69-3, 1969-1 C.B. 103; and Rev. Rul. 78-286, 1978-2 C.B. 145.

In this case, the beneficial owners of Target 1 and Target 2 will receive and retain a beneficial ownership in Newco equivalent to their interests in Target 1 and Target 2, respectively. No assets will be distributed or removed from Target 1, Target 2 or Newco.

Section 833 provides that existing X or Y 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 X or Y organization as defined in section 833(c)(2) or an organization described in section 833(c)(3).

Section 833(c)(2) defines the term “existing X or Y organization” to mean: (1) any X or Y 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 in operation of such an organization or in its structure has occurred after August 16, 1986, and before the close of its taxable year. Furthermore, any successor to an existing X or Y organization as defined in section 833(c)(2), and any organization resulting from the merger or consolidation of organization resulting from the merger or consolidation of organizations which met the requirements of section 833(c)(2), are to be treated as existing X or Y organizations for purposes of section 833 to the extent permitted by the Secretary of the Treasury.

The Conference Report regarding section 833 (section 1012 of the Tax Reform Act of 1986), 2 H.R. Conf. Rep. 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 section 833(c)(2). First, the merger or split up of one or more X or Y organizations will not constitute a material change in operation or structure. Second, if any existing X or Y 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 (that is, less than ten percent) of the assets of the existing X or Y organization at the time of acquisition, or (2) taxpayer can demonstrate to the Secretary that based on all the facts and circumstances, the acquisition does not constitute a material change in operation or structure of the existing X or Y organization from the terms and conditions in effect as of August 16, 1986. However, a material change in operation or structure occurs in an existing X or Y organization when it drops high risk coverage or substantially changes there terms and conditions under which high risk coverage is offered by the organization from the terms and conditions in effect as of August 16, 1986.

Target 1 and Target 2 represent that prior to the proposed transaction, both entities qualified as either an existing X or Y organization that was in existence on August 16, 1986 and that was exempt from tax for its last taxable year beginning before January 1, 1987. Also, Target 1 and Target 2 represent that prior to the proposed transaction, no material change had occurred in their operations or structure after August 16, 1986. Target 1 and Target 2 also represent that the consolidation will qualify as a reorganization under section 368(a)(1)(A).

The consolidation of Target 1 and Target 2 into Newco, a nonprofit, nonstock corporation, will not dilute the X or Y activities. Newco will conduct the same activities and operations after the consolidation that Target 1 and Target 2 conducted separately before the consolidation. Accordingly, based on the legislative history of section 1012 of the Tax Reform Act of 1986 and section 833, we believe that Congress did not intend that this type of change to an existing X organization and an existing Y organization should be considered a material change in operation or structure.

Based solely on the information submitted and the representations made, it is held as follows:

(1) The continuity of interest requirement set forth in section 1.368-1(b) is satisfied in each of the mergers of Target 1 and Target 2 into Newco.

(2) The consolidation of Target 1 and Target 2 into Newco will not be treated as a material change in operations or structure of Target 1 or Target 2 under section 833(c)(2)(c). The transitional rules of section 1012(c)(3) of the Tax Reform Act of 1986 continue to apply with the following limitation: at the time of sale or disposition of assets that are subject to the special basis adjustment provision of section 1012(c)(3)(A)(ii), the taxpayer must be an existing X or Y organization as defined in section 833(c)(2) to be entitled to the special basis adjustment provision.

No opinion is expressed about the tax treatment of the proposed transaction under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by the above rulings. Specifically, no opinion is given as to whether the mergers of Target 1 and Target 2 into Newco qualify as reorganizations. Furthermore, no opinion is given as to whether the mergers of Target 1 and Target 2 into Newco qualify as reverse acquisitions under section 1.1502-75(d)(3).

This ruling is directed only to the taxpayers who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter should be attached to the federal income tax returns of the taxpayers involved for the taxable year in which the transactions covered by this ruling letter are consummated.

Pursuant to a power of attorney on file with this office, a copy of this letter ruling is also being sent to your authorized representative.

Sincerely yours,

Assistant Chief Counsel

(Corporate)

By: Lewis K Brickates

Assistant to the Chief, Branch 2

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