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.

BCNEPA SUPPLEMENTAL RESPONSE TO SUPPLEMENTAL INFORMATION REQUEST 5.4.8.5.15 FROM THE PENNSYLVANIA INSURANCE DEPARTMENT

REQUEST 5.4.8.5.15

Please describe the advantages and disadvantages of permitting the Foundation to remain in existence after formation of the Public Charity. Please describe the reasons for the decision not to combine the assets of Foundation and the Public Charity and dissolve the Foundation.

SUPPLEMENTAL RESPONSE:

BCNEPA certifies to the best of its knowledge, information and belief the following:

In its response to Request 5.4.8.5.15 BCNEPA stated the following:

> The Foundation has operated for 12 years and was long ago determined by IRS to be a tax-exempt organization. As such, following the expected BCNEPA donation, the Foundation can immediately use the donated funds to expand the scope and degree of its charitable activities without having to obtain IRS approval.
>
> The rules of §4943 of the Internal Revenue Code effectively preclude private foundations from owning an entity like AHRC. Accordingly, in order that any increase in value of AHRC can accrue to the benefit of its intended charitable donees, the Public Charity will be created, in part, to accept the donation from BCNEPA of AHRC. The Internal Revenue Code requires newly formed charitable organizations to seek and obtain from IRS a favorable determination letter as to their exempt status. Because of the well-known problems at the IRS Exempt Organizations Branch,

organizations applying for recognition of their exempt status are currently experiencing waiting times in excess of 12 months for IRS to process their applications. If the Foundation were to seek to convert to public charity status, it would need a new IRS determination letter, its charitable activities would, accordingly, be impaired during the pendency of its determination letter request, and its ability to own AHRC without running afoul of the penalties and proscriptions of §4943 would remain in doubt throughout this period.

To address any potential extra expenses that may be incurred by the existence of the Foundation and the Public Charity, it is anticipated that the Public Charity and the Foundation will seek to minimize operating costs, by sharing officers, employees and facilities to the extent possible, with their compensation to be allocated between the Public Charity and the Foundation.

In further response to Supplemental Request 5.4.8.5.15, the reason not to combine the assets of the Foundation with the Public Charity and dissolve the Foundation importantly include the support requirements applicable to public charities under the Internal Revenue Code. The Public Charity will be required to receive a substantial part of its support from government grants or from contributions from the public. I.R.C. § 170(b)(1)(A)(vi). There are multiple tests used to determine if an organization qualifies as publicly supported. These tests are under I.R.C. § 509(a)(1) and 509(a)(2). The amount of public support that the Public Charity will have to receive each year will be impacted by, among other things, the amount of investment income it receives from its held investments. Generally, the Public Charity will be required to receive no more than 1/3 of its support from investment income. Therefore, the greater the investment income the greater the amount of public support. By placing a substantial portion of the $90-$100 million to be contributed to charitable organizations under the Merger Agreement in the Foundation, rather than in the Public Charity, the amount of public fundraising that will be required of the Public Charity to maintain its status will be reduced. Even with allocating only $10 million to the Public Charity, which would generate $400,000 in investment income assuming a 4% realized rate of return, the Public Charity will generally have to raise $800,000 annually in public support. This is a substantial amount of public fundraising for the community in BCNEPA's service area. It was determined that it would not be reasonable to burden that community with a greater public support need and not reasonable to assume any greater amount of public support could be raised, particularly when considering that the Public Charity will be competing for fundraising dollars with well established charities in a financially distressed community.

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