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### Blue Cross Blue Shield Insurer Entitled to Stepped-Up Basis

September 6, 2007

Alert Number: 07-67

The Court of Federal Claims, in *Highmark Inc. v. United States*<sup>1</sup>, ruled in partial summary judgment that healthcare contracts held by the successor to Pennsylvania Blue Shield are assets subject to a step-up in basis under the Fresh Start Basis Rule of the 1986 Tax Reform Act, and that the rule applies to any losses stemming from the cancellation of those contracts. The Court was only charged with hearing issues on legal arguments and did not hear any factual arguments regarding the valuation of the healthcare contracts.

Plaintiff sells health insurance as a Blue Cross/Blue Shield organization. Originally, these organizations were not subject to federal income taxes. In the Tax Reform Act of 1986, however, the Congress repealed their tax-exempt status, effective January 1, 1987. The Act included provisions such as the Fresh Start Basis Rule to ease the transition to becoming taxable entities. In particular, the Fresh Start Basis Rule provided for an adjusted basis for the organizations' existing assets, so that they would not be taxed on gains that accrued during their tax-exempt years.

In September 1995, plaintiff filed an amended return for tax year 1991, claiming loss deductions under Internal Revenue Code Section 165 for health care contracts that existed as of 1/1/87 which had been terminated or cancelled in the current year. Section 165 allows deductions for "any loss sustained during the taxable year and not compensated for by insurance or otherwise." Plaintiff's contracts originally had a basis of zero, however, Plaintiff claimed that the Fresh Start Basis Rule gave the contracts a basis equal to their fair market value on January 1, 1987, and that it suffered a loss equal to that fair market value whenever one of the contracts was terminated or cancelled after that date.

The government claimed that (1) the Fresh Start Basis Rule does not adjust the basis of plaintiff's health care contracts because, as self-created assets, their basis was zero and could not be adjusted, and (2) the provision applies only to gains or losses from the sale or exchange of property, not losses from termination or cancellation of contracts. The government's arguments relied on the premise that the phrases "any asset" and "gain or loss" are ambiguous terms.

In this case, the relevant portion of the Fresh Start Basis Rule states that "for purposes of determining gain or loss, the adjusted basis of any asset held on" January 1, 1987, will be its fair market value as of that day. Pub. L. No. 99-514, Section 1012(c)(3)(A). According to the Court, the statute clearly says that the adjusted basis applies to "any asset" a Blue Cross or Blue Shield organization held on January 1, 1987. Nothing in the plain language of the Fresh Start Basis Rule restricts its application to those assets that already had a positive basis before the statute was enacted. Without such limitations, the Court found that there was no reason to believe that "any asset" means anything other than what it says.

In addition, the Court considered the facts of several similar cases, including Trigon Ins. And Capital Blue Cross where the courts found that the health insurance contracts in that case were assets. In light of these decisions and the factual similarities among the cases, the Court held that Highmark's health insurance contracts are assets, and are therefore encompassed by the Fresh Start Basis Rule. See Trigon Ins. Co. v. United States, 215 F. Supp. 2d 687, 701, 706 (E.D. Va. 2002); Capital Blue Cross v. Comm'r, 122 T.C. 224, 237-38 (2004) rev'd on other grounds 431 F.3d 117 (3d Cir. 2005); Capital Blue Cross v. Comm'r, 431 F.3d 117, 128 (3d Cir. 2005).

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<sup>1</sup> WL 2412175, Fed.Cl., 2007



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Finally, the Court considered whether the termination or cancellation of these health care contracts qualifies as a loss under the Fresh Start Basis Rule. Although the statute itself places no limiting language on the phrase "gain or loss," the government contends that the adjusted basis in the Fresh Start Basis Rule is available only for losses resulting from the sale or exchange of assets. The Court found that it was not the intent of congress that the statute be interpreted as such. The Court determined that the Fresh Start Basis Rule applies to any losses, including those arising from the termination or cancellation of Highmark's health insurance contracts.

The government also argued that even if the Fresh Start Basis Rule applies to Highmark's loss of health care contracts from terminations or cancellations, plaintiff is not entitled to a refund because it made an unauthorized change in its accounting method when it filed its amended tax returns. The government stated that Highmark changed its method of accounting when it claimed the losses from termination or cancellation of its health care contracts, and that, by taking the loss deductions, Highmark changed the way it accounted for the costs of creating its health care contracts. Defendant argued that the adjusted basis plaintiff claimed for the contracts under the Fresh Start Basis Rule represents the cost of their creation, and that by deducting that amount Highmark had capitalized its expenses. According to the Court, the problem for the government is that the Fresh Start Basis Rule defines the adjusted basis as the fair market value of an asset, not the cost of creating it. The two values are not necessarily related. As such, Highmark did not capitalize the costs of creating its contracts and did not change its method of accounting.

In conclusion, the Court ruled that the text of the Fresh Start Basis Rule unambiguously applies to losses incurred by the termination or cancellation of Highmark's health care contracts, and Highmark did not change its accounting method when it first claimed these loss deductions. As such, the Court denied defendant's motion for summary judgment and granted partial summary judgment for plaintiff.

**PwC Observes:** This is yet another significant win for Blue Cross Blue Shield organizations from a legal standpoint. Unfortunately this case gives no further guidance or assurance on what documentation is required to support the valuation of healthcare contracts or the proper method for determining the value of healthcare contracts.

For additional information please call Anthony DiGilio at (202) 414-1702 or contact your local insurance tax professional. Please visit us at: <http://www.pwc.com/us/insurance/tax>

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