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BLUE CROSS/BLUE SHIELD AND TAX REFORM

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## ABSTRACT

The Blue Cross and Blue Shield health insurance plans, which are exempt from Federal income tax under current law, would lose their tax exemption under the House-passed Tax Reform Act of 1985. The removal of their tax exemption would obligate them to pay a substantial amount of income tax in future years if their current financial status remains unchanged. Since most of their insurance business is in the form of group policies that are competitive in benefits and pricing with the policies offered by commercial insurers, however, their tax status is likely to have very little effect on most of their group subscribers. The increased costs due to taxability would have to come primarily from their individual (nongroup) policyholders or any other elements that now benefit from their tax-exempt status.

BLUE CROSS/BLUE SHIELD AND TAX REFORM

The Tax Reform Act of 1985 (H. R. 3838), which passed the House of Representatives on December 17, 1985, repeals the tax exemptions of certain organizations that offer insurance in competition with commercial insurance companies. The most wide-spread of the affected organizations are the State-chartered corporations that make up the Blue Cross and Blue Shield health insurance plans.

The Ways and Means Committee report accompanying H. R. 3838 makes the argument that Blue Cross and Blue Shield are, in most of their operations and financial dealings, exactly like the commercial insurance carriers with whom they compete for health insurance business. Allowing them tax exemption on this part of their business, the report argues, gives them an unfair advantage over their competitors and distorts economic choices. The bill provides for the Secretary of the Treasury to make allowances by regulation for any truly charitable or social service operations in which the plans engage.

The Blue Cross and Blue Shield Association (the national organization representing the plans) concedes that most of the plans' insurance business is designed and priced to compete in the market with health insurance coverage offered by commercial carriers. They warn, however, that they also perform the socially important service of providing health insurance for many who are not insurable under the normal commercial insurance standards. Making them taxable like commercial companies might force them to behave more like those companies, many of whom refuse to insure medically high-risk individuals. They believe

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the social service they perform with respect to these high-risk individuals justifies tax exemption.

This report discusses the issues surrounding the tax exemption of the Blue Cross and Blue Shield plans from Federal income tax and the effects that repeal of the tax exemption might have on the organizations and their policyholders.

#### HISTORY AND CURRENT ORGANIZATION OF BLUE CROSS/BLUE SHIELD

Blue Cross originated as a plan for local hospitals to provide prepaid services for area residents. Hospitals were originally viewed as essentially charitable operations (most were founded with charitable or public funds), and the Blue Cross plans were simply the means of linking together many local charitable institutions and paying for their operations. For most of the early history of the plans, one rate was charged for all residents of the locality serviced by the plan. Blue Shield was added later to provide the same prepayment structure for doctors' fees, particularly surgical costs for doctors practicing in the hospitals serviced by the Blue Cross plans. The American Hospital Association was the moving force behind the establishment of the plans nationwide and was the original national coordinator of the plans.<sup>1/</sup>

Starting in the 1940s, the plans began to offer specialized features designed especially to attract unions as group members and gradually moved away from their role as the provider of prepaid community medical care (although

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<sup>1/</sup> Blue Cross and Blue Shield Association. Questions and Answers About Blue Cross and Blue Shield Organization. May 1985. Washington, D. C. p. 1-2. Cf. Law, Sylvia A. Blue Cross: What Went Wrong. Yale University Press. New Haven, 1974. p. 1-30.

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they are generally still required by their bylaws to offer some form of health insurance to otherwise uninsured residents in their communities).2/ Today, the vast majority of their business comes from employer- or union-arranged group health plans that are priced based on group experience, exactly like commercial insurance companies.3/

Originally, the benefits paid by Blue Cross and Blue Shield were entirely on a "service" basis. The plans contracted with hospitals and doctors to provide specific services (such as a specific number of days care) and paid the hospitals and doctors directly for the services. To a large degree, the plans still operate this way, although they have been offering "indemnity" benefits, which are benefits paid directly to the insured, in order to be competitive with commercial insurance plans.4/

Today, Blue Cross and Blue Shield plans differ very little in coverage or operation from the health insurance plans offered by commercial insurance companies. The plans retain elements of "social service" in that they attempt to provide low-cost health insurance to individuals who are otherwise unable to obtain affordable health insurance. They are generally governed by a board of directors chosen from area medical professionals and public representatives.5/ In many areas, a great deal of their income comes from administrative services,

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2/ Testimony of Bernard R. Tresnowski, President, Blue Cross and Blue Shield Association, before U. S. Senate Committee on Finance, February 4, 1986. (Unpublished.)

3/ Questions and Answers, p. 6. Cf. Blues Seeing Red over Plan Altering Tax Exempt Status, Journal of Commerce, January 13, 1986, p. 1C.

4/ Tresnowski testimony (note 2).

5/ Questions and Answers (note 1), p. 3-4.

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such as administering Medicare and private self-insurance health care payments.<sup>6/</sup> They are officially "not-for-profit" organizations, although the plans are sometimes said to make economic decisions that benefit board members, their member hospitals, or the medical profession generally,<sup>7/</sup> in effect passing their "profit" along to these groups. A number of the plans have accumulated enough surplus funds to buy companies in related lines of business, such as life insurance or administrative services, and now advertise that they can offer employers complete lines of employee benefits packages, including financial services.<sup>8/</sup>

Not Profit  
Surplus  
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The Blue Cross and Blue Shield plans typically cover a State, although some States contain several plans. They are State-chartered, non-profit corporations. (Several of them have recently converted into mutual insurance companies.) They are federated into a nationwide Association that sets standards, approves and audits local plans, coordinates national coverage for plan members, and acts as intermediary for national issues, such as serving as prime contractor with the Federal Government in administering the Medicare payment system.<sup>9/</sup> The national Association owns a taxable subsidiary, BCS

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<sup>6/</sup> Ibid., p. 8-9.

<sup>7/</sup> Law (note 1), p. 25-30; Eilers, Robert D., The Regulation of Blue Cross and Blue Shield Plans. Homewood, Illinois, Richard D. Irwin, Inc, 1963. p. 147-153.

<sup>8/</sup> Cf. Wisconsin Blues Take Action to Boost Competitive Position, Journal of Commerce, Dec. 31, 1984, p. 10A; Blue Cross Buys LaHood, Kansas City Business Journal, July 1, 1985, p. 1; More Profit-making Ventures on Blue Cross' Agenda, The State and Columbia Record, May 28, 1984, p. 1C, 5C.

<sup>9/</sup> Questions and Answers (note 1), p. 2.

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Corporation, that in turn owns several other businesses, including a life insurance company and a brokerage firm.<sup>10/</sup>

#### THE QUESTION OF TAX EXEMPTION

The Blue Cross and Blue Shield plans and the national Association have always been exempt from Federal income tax under Internal Revenue code section 501(c)(4), which allows tax exemption for nonprofit organizations that provide social services to broad segments of communities. The basis for the exemptions seems never to have been given in any official document, but most commentators assume it is based on three factors that were characteristic of the early plans. One factor is that the plans were distinguished from commercial insurers because they reimbursed the provider of health care rather than the subscriber to the plan: the subscriber received services rather than a fixed amount of cash, as most commercial insurance plans of that day provided. The second factor is related to pricing: by charging a flat rate to everyone in a community, heavier users of medical care in an area were subsidized by the healthier general population (rather like taxing the general population to provide for the area's heavy health-care users). The third factor was that the plans' State charters and national standards required a commitment to providing health care to low-income persons. Taken together, these factors are assumed to have persuaded the Internal Revenue Service in the 1930s to grant tax exemptions to the early plans.<sup>11/</sup>

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<sup>10/</sup> BCS Corporation. Promotional brochure. Chicago (no date). 9 p.

<sup>11/</sup> McGovern, James J. Federal Tax Exemption of Prepaid Health Care Plans. The Tax Adviser, February 1976, vol. 7, no. 2, p. 76-81.

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All of these factors have altered considerably over the years. Most of the business of today's Blue Cross and Blue Shield plans is experience-rated group insurance coverage indistinguishable in design and price from that offered by other insurance carriers.<sup>12/</sup> Most of the individual policies they offer are either supplemental Medicare policies or policies for the self-employed and others who are not eligible for group policies;<sup>13/</sup> few if any individual policyholders are poor. They do, however, continue to offer individual policies to high-risk individuals, apparently below cost, to this extent continuing to subsidize health care for some individuals.<sup>14/</sup> It is difficult to determine from their financial statements the extent of this type of coverage.

#### Repeal of the Tax Exemption

Repeal of the tax exemption for Blue Cross/Blue Shield and similar tax-exempt insurance carriers was proposed in the Treasury Department's 1984 tax reform proposals.<sup>15/</sup> The repeal provision was dropped from the "President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity"<sup>16/</sup> but was renewed for some tax-exempts, including Blue Cross/Blue Shield, in the Tax

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<sup>12/</sup> Blues seeing red (note 3), p. 1C.

<sup>13/</sup> Questions and Answers (note 1), p. 6.

<sup>14/</sup> Ibid., p. 4.

<sup>15/</sup> Tax Reform for Fairness, Simplicity, and Economic Growth, The Treasury Department Report to the President, November 1984, usually called "Treasury I," vol. 2, General Explanation of the Treasury Department Proposals, p. 286-287.

<sup>16/</sup> Sometimes called "Treasury II," May 1985.

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Reform Act of 1985 (H.R. 3838).<sup>17/</sup> The repeal proposal was dropped in the proposals currently being considered by the Senate Finance Committee.<sup>18/</sup>

The Treasury I report and the committee report on H.R. 3838 call for repeal of the tax exemption of Blue Cross/Blue Shield and certain other "nonprofit" insurance carriers because, whatever social purpose they may once have served, such organizations now serve only their own members/customers. The reports emphasize that the products, prices, and operations of Blue Cross/Blue Shield are essentially no different from those offered by the commercial insurance industry and deserve no different tax treatment. They argue that tax exemption for some insurance carriers but not for their competition constitutes Government interference in the market for no public purpose.<sup>19/</sup>

The Blue Cross and Blue Shield Association argues that the plans are different from ordinary insurance companies and the tax exemption does serve a public purpose. The Association maintains that the plans' local character, connections with local hospitals and medical professionals, and continued provision of community-rated policies for non-group subscribers shows them to be in a class by themselves, not just commercial insurance carriers. The tax exemption is justified, they argue, because of their commitment to community service and insurance coverage for otherwise uninsurable individuals. They

<sup>17/</sup> Section 1012. Cf. U. S. Congress. House. Committee on Ways and Means. Tax Reform Act of 1985. 99th Cong., 1st sess., House Rept. No. 99-426. p. 662-666.

<sup>18/</sup> U. S. Congress. Joint Committee on Taxation. Tax Reform Proposals in Connection with Committee on Finance Markup (JCS-8-86), March 18, 1986.

<sup>19/</sup> Treasury I report (note 15) and House Rept. No. 99-426 (note 17).

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point particularly to the continued exemption of health maintenance organizations (HMOs) providing health insurance.<sup>20/</sup>

#### Consequences of Repeal

Under present law and under the House tax reform bill, for-profit, commercial companies whose principal business is issuing health insurance policies are taxed as either life insurance companies or property and casualty insurance companies. If the Blue Cross and Blue Shield plans become taxable entities, therefore, they will presumably be classified as insurance companies for income tax purposes. (It is possible that some of the plans now earn so much of their income from fees for administering Medicare and self-insurance plans that insurance is no longer their predominant business activity. These plans would presumably be taxed as ordinary corporations.)

Insurance companies are subject to the corporation income tax but compute their taxable incomes somewhat differently from other corporations. The principal differences are that they are allowed deductions for money set aside to pay future claims and deductions for at least some of their dividends paid to policyholders. Insurance company taxable income is the net sum of premiums and investment income received, less claims paid and operating expenses, less additions to reserves and dividends to policyholders (which may be limited for mutual life insurance companies), and (under current law) less certain special deductions. Most of the special deductions are repealed under H.R. 3838.

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<sup>20/</sup> Tresnowski testimony (note 2). Cf. Questions and Answers (note 1), p.4.

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Financial information about Blue Cross and Blue Shield is not organized according to the categories the tax law would use to determine taxable income, so it is difficult to estimate how much tax the plans might actually be liable for. The Blue Cross and Blue Shield Association plans to have an accounting firm estimate how much the plans might owe. A study prepared for the commercial insurance industry (which supports the idea of taxing Blue Cross/Blue Shield) examined financial statements covering more than 99 percent of the 1984 insurance business of the plans and estimated that, at 1984 levels and tax rates, the plans should have paid about \$750 million in Federal income taxes in that year. This estimate is based on net income calculated for financial reporting purposes rather than tax purposes, however, so it is likely to be somewhat high. Deductions for reserves and policyholder dividends would very likely make taxable income considerably smaller than "book" income. The committee report on H.R. 3838 gave the revenue to be raised by repeal of all insurance company tax exemptions as \$2 billion for the five-year estimating period (fiscal years 1986-1990); the vast majority of this sum, \$1.7 billion, is expected to come from Blue Cross/Blue Shield.

Possible  
taxes

The exact amount of the tax increase may not be predictable, but there is no doubt that there would be a tax increase from repeal of the plans' tax exemptions. The next question, then, is who will bear the increased taxes. If the group plans are now priced (and perceived) to be competitive with plans offered by (taxable) commercial insurers, as most of them are, the additional revenue to pay the taxes cannot be raised from this source (because if they raise prices they will simply lose customers). In some localities, Blue Cross and Blue Shield enjoy a virtual monopoly in health insurance, and in many cases

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the plans enjoy a competitive advantage due to their reputation and high name recognition. Where this is the case, the plans may be able to raise group premiums to cover the increased taxes. If the plans do indeed offer below-cost coverage to classes of individual subscribers, they may be forced to forego this socially beneficial effort (because they are now presumably subsidizing this coverage at least partly from the advantage they derive from tax exemption). If some plans are actually run to benefit directors or the medical profession, as they are sometimes accused of being, then presumably some or all of the advantages of tax exemption now enure to these groups and a tax increase would fall on them as well. The managements of some of the plans have in recent years used accumulated funds to buy insurance agencies and other outside businesses; in these instances, the increase in taxes could come from the managers' discretionary funds.

In other words, making the plans taxable will very likely force them to behave more like commercial insurance carriers, leaving less money for socially desirable activities such as subsidized health insurance but also less for other activities as well. Since most of the plans' subscribers are buying competitively designed and priced group policies, the tax status of the plans should have little or no effect on most of their subscribers.

what will  
happen if  
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exemption