Capital Blue Cross and Subsidiaries v. Commissioner of Internal Revenue, 122 T. C. 224 (2004)

In a significant ruling on tax law, the U. S. Tax Court in Capital Blue Cross & Subsidiaries v. Commissioner held that the basis step-up provision of the Tax Reform Act of 1986 (TRA 1986) applies not only to sales or exchanges but also to other types of transactions, such as contract terminations. The court, however, denied Capital Blue Cross's $4 million loss deductions claimed for terminated health insurance group contracts due to inadequate valuation evidence, emphasizing the rigorous burden of proof required for such claims involving intangible assets.

Parties

Capital Blue Cross and its subsidiaries, as the petitioner, challenged the Commissioner of Internal Revenue, as the respondent, in the U. S. Tax Court regarding the disallowance of claimed loss deductions for the tax year 1994.

Facts

Capital Blue Cross, a Pennsylvania corporation, was organized as a hospital plan corporation in 1938 and operated as a tax-exempt entity under section 501(c)(4) until December 31, 1986. Effective January 1, 1987, due to the enactment of the Tax Reform Act of 1986, Capital Blue Cross became subject to federal income tax. The TRA 1986 included a basis step-up provision that allowed Blue Cross Blue Shield organizations like Capital Blue Cross to adjust the tax basis of their assets to their fair market value as of January 1, 1987, for the purpose of determining gain or loss. Capital Blue Cross claimed loss deductions under section 165 for the termination of 376 health insurance group contracts in 1994, asserting a total loss of approximately $4 million based on their valuation of these contracts as of January 1, 1987. The valuation was contested by the IRS, which disallowed the deductions, leading to the litigation in the U. S. Tax Court.

Procedural History

Capital Blue Cross filed its 1994 corporate federal income tax return claiming loss deductions of $2,648,249 related to the termination of 376 health insurance group contracts. The IRS issued a notice of deficiency on August 16, 2001, disallowing these deductions in full. Capital Blue Cross filed a petition with the U. S. Tax Court on November 13, 2001, seeking to establish the validity of the loss deductions. During the litigation, Capital Blue Cross increased its claimed loss deductions to $3,973,023 based on a subsequent valuation report. The case proceeded to trial in March and April of 2003.

Issue(s)

Whether the basis step-up provision of the Tax Reform Act of 1986 applies to losses arising from the termination of assets, and whether Capital Blue Cross adequately established the fair market value of the 376 terminated health insurance group contracts as of January 1, 1987, for the purpose of claiming loss deductions under section 165?

Rule(s) of Law

The basis step-up provision of the Tax Reform Act of 1986, as stated in section 1012(c)(3)(A)(ii), provides that “for purposes of determining gain or loss, the adjusted basis of any asset held on the 1st day of * * * [the 1st taxable year beginning after Dec. 31, 1986], shall be treated as equal to its fair market value as of such day. ” Section 165 of the Internal Revenue Code allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise, limited to the adjusted basis of the asset.

Holding

The U. S. Tax Court held that the basis step-up provision of the Tax Reform Act of 1986 applies to losses resulting from the termination of assets, not just sales or exchanges. However, the court found that Capital Blue Cross failed to adequately establish the fair market value of the 376 terminated health insurance group contracts as of January 1, 1987, and thus disallowed the claimed loss deductions under section 165.

Reasoning

The court’s reasoning was twofold. First, it interpreted the language of the TRA 1986 as clear and unambiguous, rejecting the IRS’s argument that the basis step-up provision was limited to sale or exchange transactions. The court found that the statutory purpose—to prevent taxation on unrealized appreciation during the pre-1987 tax-exempt period—was better served by applying the step-up to all types of transactions resulting in loss, including terminations. Second, the court scrutinized the valuation evidence presented by Capital Blue Cross. The court noted that the valuation methodology used by Capital Blue Cross’s expert witness, which employed a hypothetical reinsurance transaction model, did not adequately value the 376 group contracts as separate and discrete assets. The court highlighted several deficiencies in the valuation approach, including the use of average premiums and claims ratios, failure to account for contract-specific characteristics, and reliance on outdated lapse rate information. The court emphasized that the burden of proof for establishing the value of intangible assets for tax purposes is significant, and Capital Blue Cross did not meet this burden.

Disposition

The U. S. Tax Court entered a decision for the respondent, disallowing the claimed loss deductions of $3,973,023 related to the 376 terminated health insurance group contracts for the tax year 1994.

Significance/Impact

The Capital Blue Cross decision clarified the applicability of the basis step-up provision under the TRA 1986 to include losses from asset terminations, not just sales or exchanges. However, it also underscored the stringent evidentiary requirements for valuing intangible assets, particularly customer-based intangibles like health insurance group contracts, for tax deduction purposes. The ruling has implications for other tax-exempt entities transitioning to taxable status under similar provisions and highlights the challenges in valuing intangible assets for tax purposes. Subsequent court decisions and IRS guidance may reference this case when addressing similar issues involving the valuation of intangible assets and the application of statutory basis step-up provisions.

