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IRS Ruling On ObamaCare Tax Credits May Be Illegal

By DAVID HOGBERG, INVESTOR'S BUSINESS DAILY

ObamaCare directs states to set up insurance exchanges by Jan. 1. If they don't, the federal government can establish its own exchanges. The IRS ruled in May that insurance tax credits can be used in either system. But some experts argue the health law's text makes it clear that the subsidies apply in only state-run exchanges.

If so, millions of moderate-income Americans could be forced to get insurance but not be eligible for subsidies.

"The IRS rule is illegal," wrote Jonathan Adler, a law professor at Case Western Reserve University, and Michael Cannon, director of health policy studies at the libertarian Cato Institute in a new article in "Health Matrix: Journal of Law-Medicine."

They claim the IRS rule "is not authorized by the text of (ObamaCare), nor can it be justified on other grounds. Neither the structure, history, nor other indicia of congressional intent support the IRS position."

A government-run exchange is a place where people can shop and buy the health insurance required under ObamaCare's individual mandate. Those with incomes from 100% to 400% of the federal poverty level will be eligible for taxpayer-funded subsidies — a tax credit to help pay for the premium. Section 1311 of ObamaCare instructs state governments to establish exchanges. If states fail to do so, section 1321 enables the federal government to do so.

However, as IBD reported last September, the tax credit is available only to people who purchase insurance from "an exchange established by the state under (Section) 1311." Nowhere does the law say people enrolling in an exchange set up by the federal government are eligible for a tax credit.

The issue matters because the federal government may have to establish exchanges in dozens of states. Thus far, only 12 states — California, Colorado, Connecticut, Hawaii, Maryland, Massachusetts, Mississippi, Nevada, Oregon, Vermont, Washington and West Virginia — plus Washington, D.C., have passed legislation setting up a state-based exchange. The governors of New York and Rhode Island have signed executive orders to the same effect.

But governors in Florida, Louisiana, Maine, New Hampshire, South Carolina and Texas have actively opposed a state exchange. As for the remaining 30 states, it is an open question how many will meet the Jan. 1, 2013, deadline to set up a state exchange or have the federal government take over.

Thus, it is conceivable that millions of Americans could be required to purchase health insurance but live in states where they are not eligible to receive a subsidy.

Adler and Cannon argue that it was the intent of the legislators who drafted ObamaCare to use sanctions to encourage states to develop their own exchanges.

Making the tax credits available through only state-based exchanges "is consistent with (ObamaCare's) modus operandi of using financial incentives to elicit a desired behavior," Adler and Cannon wrote. Restricting the tax credits to Section 1311 is "integral to section 1311's directive that states 'shall' create an Exchange. The withholding of tax credits and subsidies in federal exchanges is the only sanction the act imposes on states that do not establish exchanges themselves."

Tim Jost, a professor at the Washington & Lee University law school, calls their argument "nonsense." He claims that federal exchanges were put into the law when Congress realized it could not constitutionally force states to set up an exchange.

"If you read Section 1321, it says a federal exchange effectively becomes a state exchange if the state elects not to set one up," he said. "So the federal exchanges can grant premium tax credits just like a state exchange."

He also notes that the Senate reconciliation bill, which was adopted after ObamaCare, assumes that tax credits will be available through federal exchanges because it imposes on both state and federal exchanges "the obligation to report to the IRS and to the taxpayer information regarding tax credits provided to individuals through the exchange."

Adler and Cannon note that is the only part of the reconciliation bill that "draws equivalence" between state and federal exchanges and that it is consistent with the rest of the law's approach to provide incentives to create a state exchange.

They also note the reconciliation bill added a section on exchanges for U.S. territories, such as Guam, and authorized those exchanges to be treated as state-based exchanges, including premium tax credits. They wrote that the "reconciliation process gave Congress the opportunity to authorize tax credits into federal exchanges, just as it authorized them in territorial exchanges. If that had been Congress' intent, then Congress would have done so."

For this to be decided by a court, someone must show that they are harmed by this provision to have standing to challenge it. Companies whose employees go to an exchange might have such standing.

Under ObamaCare, companies with more than 50 employees can face fines of $2,000 to $3,000 per employee if an employee qualifies for a tax credit through an exchange. Any company that received such a fine in a state with a federally run exchange would have standing to challenge whether the employee was eligible for the tax credit.

Everyone agrees that since the exchanges won't be up and running until 2014 at the soonest, it will be a long time before that legal challenge comes.