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How *King v. Burwell* Creates Tax Problems for Consumers and What The Treasury Can Do About It

Andy S. Grewal[1]

After the Supreme Court agreed to hear *King v. Burwell*,[2] a case addressing whether taxpayers can receive Section 36B premium tax credits for health insurance policies purchased on federally established exchanges ("federal policies"), commentators have expressed concerns about a potential death spiral in the health insurance market. Under the worst case scenario, the absence of credits for federal policies will deter consumers from future enrollment. With this smaller enrollment pool, premiums will spike sharply during the 2015-2016 Affordable Care Act enrollment season, the first following the Court's anticipated June 2015 ruling. Those price increases will further deter enrollment, and the Act will eventually collapse.[3]

This focus on future enrollment seasons masks the potentially harsh tax consequences for consumers who purchase federal policies during the 2014-2015 enrollment season. Many such consumers cannot pay the sticker price for federal policies and receive tax credits to assist with their monthly insurance payments. However, an adverse decision in *King v. Burwell* would generally require that they pay back those credits.

This conclusion might seem surprising to 2014-2015 purchasers of federal policies. Under the ACA's advance payment mechanisms, consumers seemingly take the premium tax credit immediately upon the purchase of a federal policy.[4] Unsophisticated consumers—or even sophisticated ones—can easily assume that advanced payments do not have to be paid back.[5] After all, those payments go straight to insurers and never appear on consumers' bank accounts.

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1. Associate Professor of Law, University of Iowa. Comments, corrections, and criticisms are welcome at agrewal@iowa.uiowa.edu.

2. King v. Burwell, 759 F.3d 358 (4th Cir.), *cert. granted* 135 S. Ct. 475 (2014).

3. *See, e.g.*, Jonathan Cohn, *Here's What the Supreme Court Could Do to Insurance Premiums in Your State*, NEW REPUBLIC (Nov. 11, 2014), http://www.newrepublic.com/article/120233/king-v-burwell-how-supreme-court-could-wreck-obamacare-states.

4. *See* 42 U.S.C. § 18082(a)(3) (2012) (establishing the advance payment regime). For a discussion of the rules relating to the computation of the advance payment amount, see Lawrence Zelenak, *Choosing Between Tax and Nontax Delivery Mechanisms for Health Insurance Subsidies*, 65 TAX L. REV. 723, 726-28 (2012).

5. *See* Robert Pear, *White House Seeks to Limit Health Law's Tax Troubles*, N.Y. TIMES (Jan. 31, 2015), http://www.nytimes.com/2015/02/01/us/politics/white-house-seeks-to-limit-health-laws-tax-troubles.html (noting that many consumers did not realize that advance payments may need to be paid back).

But advance payments are like loans in the sense that consumers have to repay them if those payments exceed their properly allowable tax credits. The government tentatively makes an advance payment because a consumer's premium tax credit ultimately depends on various factors, including the consumer's annual household income, which cannot be accurately determined until the end of the taxable year.[6] Consequently, anyone who receives advance payments must file a tax return to demonstrate her entitlement to the premium tax credit.[7] If the advance payments exceed the allowable tax credit, Section 36B(f) requires that the consumer pay back the excess.[8]

Excessive advance payments commonly arise when a consumer estimates her credit using a household income lower than the actual income for the year.[9] Under Section 36B, the allowable credit shrinks as income increases, so underestimation of income generally causes a consumer to overstate her anticipated credit.[10] Excessive payments will also arise if the government loses *King v. Burwell* because any advance payment on a federal policy would necessarily exceed the proper credit of $0.

Although it might seem harsh, this result follows from the Tax Code's annual accounting rule.[11] Under the Code, transactions generally do not independently establish tax credits or liabilities. That is, a consumer does not earn a credit simply by purchasing a health policy, whether on a federal exchange or a state exchange, and a consumer does not face a tax liability simply because, for example, he sold property for a big gain.[12] The year as a whole requires examination.[13] And if the Court decides *King v. Burwell* against the government, that end-of-year examination will show that purchasers of federal policies were entitled to no premium tax credits.

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6. Regulations provide detailed rules related to the computation of the premium tax credit. *See* Treas. Reg. §§ 1.36B-1 to -4 (2012).

7. *See* Treas. Reg. § 1.36B-4(a)(1)(i) (2012) ("A taxpayer must reconcile the amount of credit allowed under [S]ection 36B with advance credit payments on the taxpayer's income tax return for a taxable year.").

8. Technically speaking, the statute increases the taxpayer's tax liability for the taxable year on account of the excess credits. *See id.* When a taxpayer's household income is below 400% of the poverty line, Section 36B(f) limits this increase. In these circumstances, the increased tax liability will be limited to between $600 to $2,500, depending on income. *See* 26 U.S.C. § 36B(f)(2)(B)(i) (2012).

9. *See, e.g.*, Treas. Reg. § 1.36B-4(a)(4) (2012). The Department of Health and Human Services (HHS) has issued guidance under 42 U.S.C. § 18082(b)(1) (2012) regarding income estimates.

10. *See* 26 U.S.C. § 36B(b)(2)(B)(ii)-(b)(3)(A) (2012).

11. *See* 26 U.S.C. §§ 441(g), 446(a) (2012) (codifying the Tax Code's annual accounting rule, which provides that taxable income shall be computed on the basis of the taxpayer's taxable year, which is usually the calendar year for individuals); *see also* 26 U.S.C. § 36B (2012) (noting that Section 36B and related provisions "apply to taxable *years* ending after December 31, 2013," not to coverage months (emphasis added)).

12. Spring City Foundry v. Comm'r, 292 U.S. 182 (1934) (holding that gains from the sale of goods early in the year accrued as gross income even though later events in the same year established doubts about full collectability).

13. *See* Burnet v. Sanford & Brooks Co., 282 U.S. 359, 365 (1931) ("The computation of income annually as the net result of all transactions within the year was a familiar practice, and taxes upon income so arrived at were not unknown, before the Sixteenth Amendment.").

However, Section 7805(b)(8) may provide some relief to consumers.[14] Under that statute, the Treasury can deny retroactive effect to judicial rulings, even ones made by the Supreme Court. But any action by the Treasury will fully protect only those who purchased federal policies during the 2013-2014 enrollment season. Purchasers of federal policies during the current enrollment season will not definitively establish their right to tax credits until after December 31, 2015, approximately six months after a potentially adverse decision in *King v. Burwell*.[15] These taxpayers would need the Treasury to deny prospective effect to the Court's ruling, a power not contemplated by Section 7805(b)(8).

Arguably, Section 36B reflects a departure from the annual accounting concept, and the Treasury can use Section 7805(b)(8) to protect any advance payments processed before *King v. Burwell* takes effect. Under Section 36B, the eligibility for a premium tax credit turns on a month-by-month analysis even though a consumer's actual tax credit or liability depends on annual household income and other factors established at the end of the year.[16] Consequently, the Treasury might treat consumers as having established their right to tax credits at the close of each month and might establish some type of pro-ration regime for computing allowable credits.[17]

But even under this scenario, consumers face potential problems. In the months after *King v. Burwell* takes effect, no credit related to a federal policy would be allowable, and taxpayers would have to repay any advance payments made for those months. Alternatively, the government might stop making advance payments on federal policies in July 2015, such that taxpayers would effectively see an unaffordable spike in their monthly premium payments. Either way, trouble awaits.

Also, although Section 7805(b)(8) may provide relief for pre-*King v. Burwell* months, there's no guarantee that the Treasury will exercise its

14. In full, 26 U.S.C. § 7805(b)(8) provides, "The Secretary may prescribe the extent, if any, to which any ruling (including any judicial decision or any administrative determination other than by regulation) relating to the internal revenue laws shall be applied without retroactive effect." 26 U.S.C. § 7805(b)(8) (2012).

15. Absent a rehearing or other unusual development, the Court will issue its decision in *King v. Burwell* by the end of June 2015.

16. *See* 26 U.S.C. § 36B(b)(1) (2012) (calculating the annual healthcare credit by reference to "coverage months"); *see also* Treas. Reg. § 1.36B-2(a) (2012) (allocating "premium assistant amount[s]" by month).

17. *See* Cent. Laborers' Pension Fund v. Heinz, 541 U.S. 739, 748 n.4 (2004) (holding that the IRS can invoke authority under Section 7805(b)(8) to protect plans that, under the Court's ruling, failed Section 411(d)(6)'s requirements); *see also* Rev. Proc. 2005-23, 2005-1 C.B. 991, *as modified by* Rev. Proc. 2005-76, 2005-2 C.B. 1139 (stating that a plan will not lose tax-exempt status under *Heinz* where plan terms are retroactively changed to the date of and reflect the holding of that case). The *Heinz* case dealt with a statutory regime that does not translate well to the Section 36B premium tax credit regime—Section 411(d)(6) contemplates continuous compliance with a restriction, not a computation of an allowable credit based on factors known only at year-end. Still, *Heinz* provides some support for the Treasury to allow tax credits for a taxpayer's coverage months preceding any adverse decision in *King v. Burwell*.

authority under that statute, given the potential blowback it might face.[18] If the Treasury flatly rules that *King v. Burwell* does not apply for the months preceding the Court's decision, penalties on individuals and employers would follow. That is, the individual penalty for failure to obtain coverage and the employer penalty for a failure to provide coverage depend, in part, on whether Section 36B extends to consumers who purchase federal policies.[19] If the Treasury broadly denies retroactive effect to *King v. Burwell*, then some individuals and employers will find themselves paying penalties even though they prevailed in the Supreme Court. Although it is doubtful that Section 7805(b)(8) was intended to let the Treasury rob taxpayers of judicial victories, the statute's plain text does not force the Treasury to exercise its authority in a purely taxpayer-favorable manner.[20]

Arguably, the Treasury can turn off *King v. Burwell* only for consumers who purchase federal policies and allow it to take full effect for other individuals and for employers. Section 7805(b)(8) allows the Treasury to "prescribe the *extent*, if any, to which any ruling" operates without retroactive effect. The Treasury might thus deny retroactive effect to *King v. Burwell* only to the "extent" that it protects a consumer's tax credits for federal policies, but no further.

However, it is not obvious that Section 7805(b)(8) allows the Treasury to slice and dice a judicial decision that way. Instead, Section 7805(b)(8) might refer solely to temporal elements, not substantive ones. That is, the Treasury can choose only the "extent" of *King v. Burwell*'s retroactivity period and may prescribe, for example, that it takes effect as of June 1, 2015, or as of May 1, 2015, or as of some other date. Under this reading, the Treasury could not chop up the Court's holding; it would have to accept the decision *in toto*, subject to whatever period of retroactivity it chooses.

The case law provides little guidance on the Treasury's authority under Section 7805(b)(8) to deny retroactive effect to judicial decisions. Although the Tax Code has long provided the Treasury the authority to deny retroactive effect to its own rules, the extension of the Treasury's authority to judicial rulings came relatively recently, via a 1996 statutory amendment. And it is not

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18. The government has refused to share its planned response to any adverse decision in *King v. Burwell* and has made no promises regarding Section 7805(b)(8). *See* Sarah Ferris, *Defiant Health Chief Says ObamaCare Will Win Day at Supreme Court*, HILL (Dec. 23, 2014), http://thehill.com/policy/healthcare/227964-defiant-health-chief-says-obamacare-will-win-day-in-court (noting that HHS Secretary Burwell "declined to say whether the administration had a contingency plan for the potential loss of $64 billion in subsidies, adding: 'I'm going to stick with where I am'").

19. *See* 26 U.S.C. § 4980H(a)(2)-(b)(1)(B) (2012) (imposing penalties on an employer when a tax credit is allowed with respect to an employee's purchase of a qualified health plan); King v. Burwell, 759 F.3d 358, 365 (4th Cir. 2014) (explaining how availability of credits partly determines whether an individual can satisfy the unaffordability exception to the individual mandate, such that she can escape penalties for failing to obtain health insurance).

20. Of course, other statutes could impose limitations on the Treasury's taxpayer-adverse exercise of authority under Section 7805(b)(8). *See, e.g.*, Administrative Procedure Act, 5 U.S.C. § 706(2)(A) (2012) (providing that courts shall set aside agency action when discretion has been abused).

clear that the Treasury's authority under Section 7805(b)(8) applies to judicial rulings in the same way that it applies to agency rulings. It makes sense for the Treasury to determine the retroactive effect of its own rulings (whether along substantive or temporal lines), but slicing and dicing the substance of a Supreme Court ruling appears to intrude on judicial power.[21]

Given the complications of the annual accounting rule and the ambiguity over Section 7805(b)(8), the Court itself might take steps to protect consumers who purchase federal policies. Although the Court seems to have adopted a "firm rule of retroactivity" for civil cases,[22] commentators argue that some issues remain unsettled.[23] If the Court has the power to stay or delay the effect of its decision in a statutory case,[24] policy concerns may support the exercise of that power. However, issuing a decision that applies only prospectively stands in tension with the judiciary's proper role.[25]

Congress, of course, could adopt a commonsense statute that protects purchasers of federal policies during the current enrollment season. But a legislative fix seems unlikely given the strained relationship between the President and Congress. It is unfortunate that the people who can most easily protect purchasers of federal policies probably will not reach a sensible compromise.

Going forward, Congress should act cautiously before it houses a public assistance program in the Tax Code. Had Congress provided direct payments to assist with the purchase of policies, rather than tax credits, consumers, employers, and the Obama Administration could have avoided the complications discussed above. But when Congress uses the Tax Code, it incorporates all of its machinery, including the annual accounting rule. That

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21. The Court of Appeals for the Second Circuit has reserved its judgment on whether the Supreme Court's "retroactivity rule or other legal principles might constrain the IRS's authority to limit the retroactive effect on the rights of parties of judicial decisions" under Section 7805(b)(8). Swede v. Rochester Carpenters Pension Fund, 467 F.3d 216, 221 n.9 (2d Cir. 2006). The Treasury has applied Section 7805(b)(8) to a judicial decision only once, when the Court itself directed the Treasury to consider exercising its statutory authority. *See* Rev. Proc. 2005-23, 2005-1 C.B. 991, *as modified by* Rev. Proc. 2005-76, 2005-2 C.B. 1139 (following the Court's suggestion in Cent. Laborers' Pension Fund v. Heinz, 541 U.S. 739, 748 n.4 (2004)).

22. Landgraf v. USI Film Prods., 511 U.S. 244, 278 n.32 (1994) (citing Harper v. Virginia Dept. of Taxation, 509 U.S. 86 (1993) (*Harper*)).

23. *See* LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW § 3-3, at 226 (3d ed. 2000) ("[The] Court [in *Harper*] did not hold that all decisions of federal law must necessarily be applied retroactively. . . . [T]he Court has not renounced the power to make its decisions entirely prospective, so that they do not apply even to the parties before it." (emphasis removed)); *see also* Nunez-Reyes v. Holder, 646 F.3d 684, 698 (9th Cir. 2011) (en banc) (concluding that the Court has not expressly overruled Chevron Oil Co. v. Huson, 404 U.S. 97 (1971), and that courts can limit the retroactive effect of their decisions in narrow circumstances).

24. In a pre-*Harper* case, the Court stayed its judgment to allow Congress time to amend a statute to cure its constitutional defects. *See* N. Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982).

25. *See* Am. Trucking Ass'ns, Inc. v. Smith, 496 U.S. 167, 201 (1990) (Scalia, J., concurring) ("[P]rospective decisionmaking is incompatible with the judicial role, which is to say what the law is, not to prescribe what it shall be."). *See generally* Bradley Scott Shannon, *The Retroactive and Prospective Application of Judicial Decisions*, 26 HARV. J.L. & PUB. POL'Y 811, 874 (2003) (arguing that prospectivity's costs outweigh prospectivity's benefits).

rule may jeopardize the availability of credits for federal policies purchased during the current ACA enrollment season and may discourage signups.[26]

26. *Cf.* Lawrence Zelenak, *Choosing Between Tax and Nontax Delivery Mechanisms for Health Insurance Subsidies*, 65 TAX L. REV. 723, 731 (2012) ("A person who is eligible for advance payments based on predicted income, and whose actual subsidy-year income is also in the targeted range, may decide not to participate because of the threat [of Section 36B(f)].").