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The Internal Revenue Service meets the Affordable Care Act

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INTRODUCTION

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The Internal Revenue Service (IRS) is the government agency that Americans love to hate the most. And on April 15, 2015, the IRS will implement, for the first time ever, the mandate in the Affordable Care Act (ACA)—a law that a large part of the public, mostly conservative, loves to hate as well. Regardless of the reality of how things go, the combination of the IRS and the ACA guarantees complaints from politicians and the public alike.

Ever since its passage, the mandate that every American have health insurance has been at the heart of the controversy over the ACA. The mandate is enforced through the tax code and the Internal Revenue Service enforces the tax code. Beginning this year citizens will find some new boxes to check and some new forms to fill out as they complete their tax returns. The experience Americans have this first time around will almost certainly bring about criticisms—and whether they are significant and will add to the incredible amount of political opposition this law has faced or whether they are simply growing pains that will fade away – these complaints will have repercussions for the 2016 elections and beyond.

CHANGES IN TAX FILING

Come April 15th approximately 150 million Americans will file income tax returns (149.7 million were filed in 2014). They will notice some changes. For some the changes will be minimal – for others not. The changes are listed below in order of complexity.

For the vast majority of taxpayers the new law should not complicate their tax filing very much. If everyone in the family had health insurance through their employer or through the private marketplace the only thing they will have to do is to check a box. On form 1040 this will be on line 61 and on form 1040 EZ this will be on line 11.[1] The IRS has issued new W-2 forms, which include, in Box 12, a requirement that employers provide information to the IRS on whether or not they are providing health insurance and the value of that insurance.

Those who took advantage of the new exchanges created by the ACA to buy health insurance will receive a newly created form—1095A. These forms will be sent from the newly created federal and state health insurance exchanges to everyone who has purchased health insurance through the exchanges, currently somewhat more than 11 million people (although like everything else associated with this law the number of people who have signed up is controversial.) The first glitch has already occurred. According to U.S. News and World Report: "Unfortunately for about 800,000 of the people who used the federal site, their 1095-A forms contained incorrect information. If you were one of them, you should have been contacted by the Centers for Medicare and Medicaid Services, who asked all affected individuals to delay filing taxes and wait for the correct form. That new 1095-A should be sent out this week, but all affected people are eligible for a filing extension. That error affected about 20 percent of people using the federal marketplace."[2] Nonetheless, filing the 1095A exchange form shouldn't pose too big of a problem for those who get the proper form.

The level of complexity increases exponentially for those who need to file the new form 8962 – the Premium Tax Credit. This form exists because, under the law, those who earn between 100 percent—400 percent of the poverty line are entitled to a tax credit to help them offset the cost of health insurance.[3] However, an individual's income can change over the course of a year. And thus some people will have gotten government help buying health insurance when they shouldn't have and vice versa. So this year people will have to reconcile the government assistance they received with their actual 2014 income. Once you do the calculations on form 8962 if it turns out that you were NOT entitled to the tax credit after all you will have to repay it, and if you are entitled but didn't receive government assistance you can get it.[4] This may affect an individual's tax bill or the size of their refund.[5]

And then there is the tax penalty – euphemistically called "the individual shared responsibility payment." If someone goes without insurance for more than three months they must pay a penalty. Unlike other taxes the IRS levies, however, there are limits on what the IRS can do to you if you don't pay your taxes. For instance, the agency is not permitted to garnish wages, seize your assets, or place liens on your property as it can for noncompliance with other tax payments. The IRS will levy the health tax penalty by reducing the refund owed to a person or by increasing the size of their tax bill. For 2014 the size of the penalty is fairly small—$95 or 1 percent of annual income per person—whichever is greater.

According to the tax preparation company TurboTax, "the average penalty will be $301 this year, but it's set to increase each year, at least for the next two years. Next year, the fee increases to $325 per adult and $162.50 per

1 See IRS, Affordable Care Act & Taxes—At a Glance, February 6, 2015 (http://www.irs.gov/Affordable-Care-Act/Individuals-and-Families/Health-Care-Law-and-Your-Tax-Return)

2 Lacie Glover, "Health Insurance and Your Taxes: What to Know," *Yahoo News*, March 12, 2015 (http://news.yahoo.com/health-insurance-taxes-know-151615537.html;_ylt=A0LEVr78EvtUAKEAN_EnnIlQ)

3 There are some exceptions to this rule. See IRS, Questions and Answers on the Premium Tax Credit, March 27, 2015 (http://www.irs.gov/Affordable-Care-Act/Individuals-and-Families/Questions-and-Answers-on-the-Premium-Tax-Credit)

4 Lacie Glover, "Health Insurance and Your Taxes: What to Know," *Yahoo News*

5 Ann Carrns, "Tax Returns Complicated by Health Care Law and I.R.S. Staff Cuts," New York Times, January 7, 2015 (http://www.nytimes.com/2015/01/08/your-money/tax-returns-complicated-by-health-care-law-and-irs-staff-cuts.html?_r=0) child, capped at $975, or 2 percent of income. If you owe a penalty this year, it might not be too bad, but it's up to you to assess whether it's worth it to pay the penalty going forth, since it will rise again in 2016."[6]

Turbo Tax says that about half of the 40 million Americans who went without health insurance in 2014 will qualify for an exemption from the penalty. Whether they claim that exemption, however, is another story. First of all, exempt individuals need to know that they qualify for an exemption. Exemptions are available for a number of people. You can get an exemption if your income was too low, if your lack of coverage was only for three months or less, if the lowest price health insurance in your area amounts to more than 8 percent of your income, if you are part of a Native American tribe, if you are in the U.S. illegally, if you are a member of a health care ministry, if you are in jail, if your religion objects to insurance or if you quality for a hardship exemption. Or you can get an exemption if you declined an offer of a job-based plan that started in 2013 and ended in 2014 or if you enrolled a child in the Children's Health Insurance Program during the 2014 period and didn't have coverage for the child earlier in the year. Once an individual determines that they qualify for one of the above exemptions, they then need to understand how to fill out the paperwork and fill out yet another new form—IRS form 8965, Health Coverage Exemptions.

THE CHALLENGES

Though there are other changes to the tax code that result from the new law, the changes listed above are likely to cause the most confusion and complaints because they affect the most people. Two big problems will confront the IRS as it heads into the first year of implementing provisions of the Affordable Care Act—one is the result of staffing and operational cuts; the second is the result of the mandate enforcement mechanisms built into the law.

As we've seen, the new law increases the complexity of filing one's taxes—especially for those who have taken advantage of the ACA. In spite of all the complaining about the IRS, for many Americans of average means tax filing is pretty simple. In fact, 15.9 percent or 23,053,156 Americans filed form 1040 EZ – the simplest of three tax forms you can use to file federal income taxes, for single and joint filers with no dependents—in 2012, the last year for which there's data.[7] In order to file the 1040 EZ a person's income needs to be less than $100,000. This means that many of those who took advantage of the new health care options and subsidies available under the Affordable Care Act are also accustomed to filing a simple return. This year they will be confronted with the need to deal with the 1095A form, the 8962 form or the 8965 form.

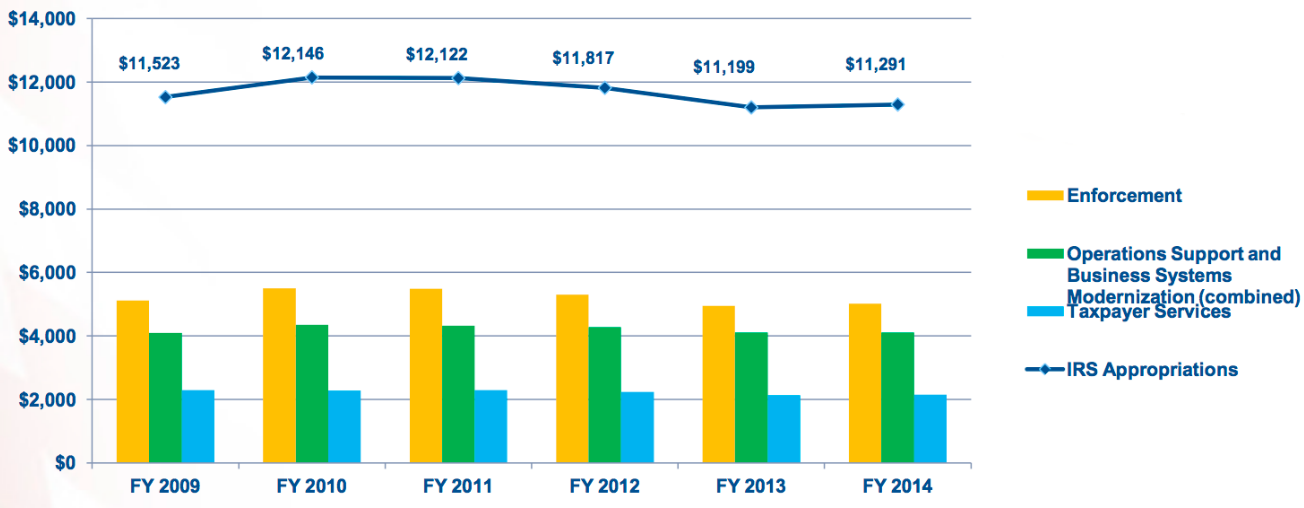
Had Congress seen fit to increase the staff or operating budget of the IRS in order to help people sort out the new tax implications of the health care law it could have provided assistance to those who need it. But in fact the opposite happened. Republican anger at the scandal surrounding IRS treatment of Tea Party affiliated groups and general antipathy to the IRS have contributed to a sorry state of affairs and repeated cuts to the IRS budget over the past few years. As the new IRS Commissioner told Congress "We're well beyond cutting out any fat. And we're now into cutting, as people say, muscle headed toward bone."[8] Overall IRS appropriations have declined to slightly below

6 Lacie Glover, "Health Insurance and Your Taxes: What to Know," *Yahoo News*

7 See IRS Publication 4801, "Individual Income Tax Returns Line Item Estimates, 2012," Revised October, 2014 (www.irs.gov/pub/irs-soi/12inlinecount.pdf)

8 Bernie Becker, "IRS officials warn: We're nearly crippled," *The Hill*, December 21, 2014 (http://thehill.com/policy/finance/227764-irs-warns-were-nearly-crippled) what they were in 2009—before the ACA was passed. In addition as the Government Accounting Office indicates in the chart below, staffing has gone down from 2009 to 2014 including in the all-important area of taxpayer services.[9]

Figure 1: Staffing Trends, IRS has reduced FTEs by about 8,000 (9 percent) since fiscal year 2009



Source: Government Accountability Office report, "Absorbing Budget Cuts Has Resulted in Significant Staffing Declines and Uneven Performance."

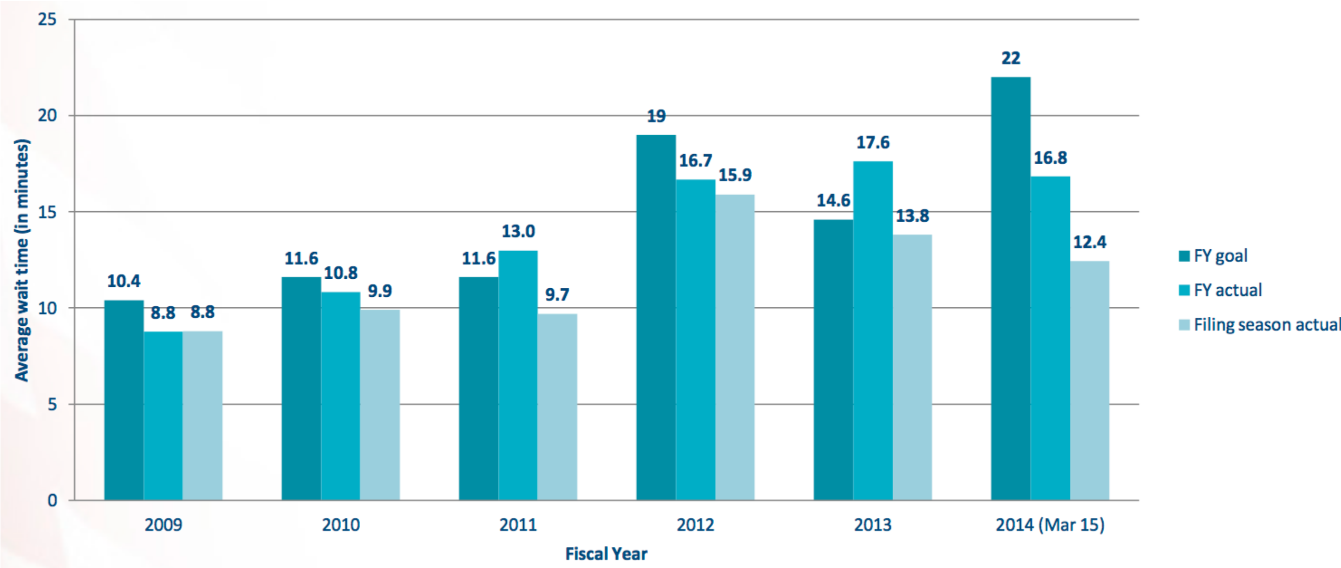
Not surprisingly, service has suffered. Average wait times on IRS customer service lines have doubled from 2009 to 2014, from 8.8 minutes to 16.8 minutes and wait times during the tax filing season have increased as well, from 8.8 minutes to 12.4 minutes. And this was before Americans had to take the new health care law into account when doing their taxes. In June of 2014, IRS Commissioner John Koskinen warned: "If we don't receive the funding and we can't do the hiring needed to handle this call volume, we estimate our level of phone service next year would plunge to 53 percent, which would be our lowest since 2008. At 53 percent, that would mean close to half of those trying to get our help over the phone would not get through."[10] And even if someone gets an IRS representative on the phone, taxpayer support staff is limited to answering only basic question topics and services at IRS walk-in centers have been reduced.[11]

9 GAO Report 14-534R Internal Revenue Service, "INTERNAL REVENUE SERVICE: Absorbing Budget Cuts Has Resulted in Significant Staffing Declines and Uneven Performance," April 21, 2014 (http://www.gao.gov/assets/670/662681.pdf)

10 Brianna Ehley, "Can IRS Collect Obamacare Taxes When It Can't Handle Tax Complaints?" *The Fiscal Times,* September 7, 2014 (http://www.thefiscaltimes.com/Articles/2014/09/07/Can-IRS-Collect-Obamacare-Taxes-When-It-Can-t-Handle-Tax-Complaints)

11 "IRS budget cuts will compound taxpayer frustration," *The Washington Post,* January 19, 2015 (http://www.washingtonpost.com/opinions/irs-budget-cuts-will-compound-taxpayer-frustration/2015/01/19/d58ad862-9dcc-11e4-bcfb-059ec7a93ddc_story.html)

Figure 2: Performance trends, average wait times have generally increased since 2009



Source: Government Accountability Office report, "Absorbing Budget Cuts Has Resulted in Significant Staffing Declines and Uneven Performance."

The second issue likely to cause controversy is the fact that some portion of Americans will see tax refunds that aren't as big as they expect them to be. A huge number of Americans actually get refunds from the IRS. In fact in 2014 the IRS doled out 109,499,000 refunds or fully 73 percent of all tax filers got a refund![12] So far this year the average tax refund is $2,853—although the average refund for the low and moderate income earners who are likely to be customers of the new health care bill is probably lower than the overall average.

In anticipating what will happen as the new law is implemented it is important to understand that many low and moderate income Americans use the IRS as a sort of savings account. From a purely economic standpoint this is a suboptimal form of saving. Since the IRS does not pay interest on the extra taxes it keeps during a year and then gives back, someone who over withholds is actually losing money. In addition, many low and moderate income tax payers take out "refund anticipation loans" and pay a fee so that they can borrow against their tax returns. And, of course, many pay a hefty fee to tax preparers in order to get their refund.

A few years ago, the economists Michael Barr and Jane Dokko studied the question of why people would over withhold when it doesn't make much financial sense. Using survey data on individuals from the Detroit metropolitan area they found that over withholding was a conscious form of savings—taxpayers were, in fact, willing to forego interest in order to get a guaranteed refund. "That tax filers want to over-withhold means they are willing to pay in order to save. Given an average refund of $1700, a LMI [low moderate income] tax filer is willing to forego $45 in interest in order both to save in a temporarily illiquid asset as well as to restrict the availability of consumption opportunities."[13] Not surprisingly, they found that the more illiquid a taxpayer's assets were, the more they were willing to over withhold.

12 See IRS, Filing Season Statistics for Week Ending March 27, 2015, (www.irs.gov/uac/2015-and-Prior-Year-Filing-Season-Statistics)

13 Michael S. Barr and Jane K. Dokko, "Paying to Save: Tax Withholding and Asset Allocation Among Low and Moderate Income Taxpayers," (Washington D.C., Federal Reserve Board, Paper 2008-11, December 2007) p. 28.

So for some individuals – those who do not get covered, but are not exempt through the ACA—the “savings” they expect to get from over withholding could be greatly reduced by their failure to purchase health insurance. For this year the penalties are rather small but in the future the penalties will increase. By 2016 they will jump to 2.5 percent of income. At that rate, the penalty will certainly wipe out the anticipated “savings” of low and moderate income people who expect refunds after tax season and who have grown accustomed to “saving” through the tax system.

The IRS cannot pursue criminal or civil penalties in order to collect the tax penalty in the Affordable Care Act. This makes it seem as if the law has a giant loophole in it. But, in fact, it does not. It would make little sense to pursue civil or criminal penalties against a population that simply doesn’t have much money; the ACA is available only to those under 400 percent of the poverty line. But, as we have seen, substantial portions of this low to moderate income population do over withhold in order to get tax refunds. So people were wrong to think that the mandate was effectively unenforceable—the IRS will simply take the penalty out of people’s refunds, and in the vast majority of cases that will suffice. But as people see their refunds significantly decreased, there may well be a strong political backlash against the law. Those who use their refund as a savings mechanism will be none too pleased at the unexpected bite out of their yearly windfall. The penalty may, however, end up convincing people to buy health care even if they don’t want to.

CONCLUSION

In spite of all the controversy over President Obama’s health care law, the problems in the initial disastrous roll-out have been mostly solved. Tax day 2015 represents the next big test in the implementation of this highly controversial law. Given the staff limitations of the IRS and the complexity of reporting and reconciling the government subsidies in the law with people’s income there is likely to be confusion, frustration and, most important, a lot of people who find out that their tax refund is a great deal smaller than they anticipated.

Massachusetts has had a tax penalty for not having health insurance since the passage of the state’s 2006 health care reform law.[14] Starting in 2007 taxpayers had to show proof of health insurance coverage. Individuals in Massachusetts who can afford health insurance but who lack coverage are assessed a penalty—loss of their personal exemption in the first tax year, worth approximately $219 per person—and, like the ACA’s tax structure, have been subject to an increasing penalty amount every year since implementation. Massachusetts has had great success in citizens’ compliance with health reform and new tax filing procedures. Only 1.45 percent of Massachusetts filers failed to comply with completing the new health tax form in the first year and compliance has remained high, with nearly 100 percent of Massachusetts residents successfully filing the proper tax forms. Even more, the number of both full-year and part-year uninsured tax-filers who are assessed a penalty in Massachusetts has dropped consistently each year since 2007.

However, one should be cautious before assuming this high-rate of compliance will be easily replicated at the federal level on tax day. Massachusetts had an uninsured rate that was significantly lower than the national average, even before it passed the 2006 reform bill.[15] More importantly, Massachusetts had a favorable political environment and

14 Massachusetts Legislature, Acts of 2006, Chapter 58. See Alan G. Raymond, “Massachusetts Health Reform: A Five-Year Progress Report,” November 2011 (https://www.power2u.org/downloads/Mass-health-care-reform-2011.pdf)

15 See Kaiser Family Foundation, State Health Facts (http://kff.org/other/state-indicator/total-population/)

the public generally embraced the state law – including the individual mandate[16]—whereas the ACA has struggled for both political and public support.

For reasons noted above, the federal experience is not likely to be as smooth. The Obama administration has shown a wise tendency to delay implementation of parts of this law. They have already extended deadlines for individuals who received inaccurate forms and they have delayed entire sections of the law dealing with small business requirements.

They should apply the same caution to this first tax season. The continued opposition to the law, including the pending Supreme Court challenge in King v. Burwell[17]—means that this enforcement season could be a tough one. To survive, the IRS should give taxpayers a break whenever it can.

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16 Robert Blendon et. al., "Massachusetts Health Reform: A Public Perspective From Debate Through Implementation," *Health Affairs,* Vol. 27 No. 6 (November 2008).

17 See *King v. Burwell*, argued before the Court on March 4,2015

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