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David Gamage
*Indiana University Maurer School of Law, dgage@indiana.edu*

Darien Shanske
*University of California, Davis*

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Why the Affordable Care Act Authorizes Tax Credits on the Federal Exchanges

by David Gamage and Darien Shanske

David Gamage is an assistant professor at the University of California Berkeley School of Law (Boalt Hall) and Darien Shanske is a professor at the University of California Davis School of Law (King Hall).

This column was substantially complete in December 2013, before the U.S. District Court for the District of Columbia in Halbig v. Sebelius upheld the use of tax credits. We agree with the decision and supplement the court's analysis.

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Despite the Supreme Court’s landmark decision in 2012, litigation over the Affordable Care Act (more commonly known as “Obamacare”) continues. In this article, we evaluate the lawsuits and related questions stemming from whether a state chooses to establish an American health benefit exchange.

The ACA directed each state to establish an exchange no later than January 1. Those exchanges will administer the ACA’s new premium tax credits and cost-sharing subsidies. Employers are subject to the ACA’s employer mandate penalties only to the extent that their employees receive premium tax credits. Tax lawyers and others advising employers on their potential liability for the employer mandate penalties must therefore understand the rules governing whether employees can qualify for the premium tax credits within each state.

States may opt to not establish an exchange. If a state chooses this option, the federal Department of Health and Human Services “shall . . . establish and operate such Exchange within the State. . . .” A majority of states have opted not to establish an exchange, and HHS is establishing federal exchanges to operate in those states. The same penalties apply on federal exchanges, assuming that the tax credits are available on those exchanges.

Jonathan Adler and Michael Cannon have argued that the ACA only authorizes premium tax credits within states that establish an exchange. According to their argument, taxpayers in states that opt to not establish those exchanges will not be eligible for the premium tax credits and employers will not be subject to the ACA’s employer mandate penalties.

Adler and Cannon’s argument has received a great deal of attention over the past couple of years. In November 2011 a group of 26 Republicans in the U.S. House of Representatives wrote to then-IRS Commissioner Douglas Shulman in support of Adler and Cannon’s claim that the Treasury Department and the IRS lack authority to grant premium tax credits to individuals who receive health coverage through an HHS-established exchange. In August 2012 the House Oversight and Government Reform Committee held a hearing on the issue, during which Rep. Scott DesJarlais, R-Tenn., called on Treasury and the IRS to withdraw the portion of their regulation ruling that premium tax

2PPACA section 1311(b)(1).
3Id. at section 1513.

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credits are available from HHS-established exchanges.8 This regulation is currently being challenged in several lawsuits, most notably in Oklahoma ex rel. Pruitt v. Sebelius,9 filed by Oklahoma’s attorney general, and in Halbig v. Sebelius,10 filed by a separate group of plaintiffs.11 In this article, we refute Adler and Cannon’s argument and the plaintiffs’ positions in Pruitt and Halbig.12

We analyze the text of the ACA as a noncontroversial starting point. Of course, approaches to statutory interpretation are legion. For the sake of simplicity, we will apply the “fair reading” approach recently and forcefully advanced by Justice Antonin Scalia and Bryan Garner in their book Reading Law.13 This method treats the text as supreme and famously eschews legislative history, but even this approach values indication of a text’s purpose as provided by the text itself: “The evident purpose of what a text seeks to achieve is an essential element of context that gives meaning to words.”14 In order to tease out the meaning of a text, Scalia and Garner argue for the prudent use of canons of construction, which are just the default interpretive presumptions that courts apply to statutes. We will follow them in their deployment of these canons, though they are also disputes as to what the canons are and how they operate. We are deliberately using the minimalist set of canons embraced by Justice Scalia, not because we necessarily agree with them, but because we think that if these canons point strongly in one direction, then we are on solid ground.

Adler and Cannon argue that the “plain text of the [ACA] precludes” providing credits for use on federal exchanges.15 We argue below that this is incorrect. Indeed, the better reading of the statute is that tax credits are to be available on HHS-established exchanges. However, it is important to note that if we cannot resolve the disagreement about the interpretation statute’s text, we have certainly established that the statute is ambiguous, a fact that has important implications. Congress has granted the Treasury Department and the IRS considerable discretion in interpreting ambiguous tax statutes in general and this tax statute in particular.16 Consequently, despite Adler and Cannon’s arguments to the contrary, Treasury and the IRS clearly possessed the authority to interpret the ACA as allowing premium tax credits on HHS-established exchanges.17

A. Definition of Exchange

The interpretive issue here largely revolves around the word “exchange.” Scalia and Garner instruct that “definition sections and interpretation clauses are to be carefully followed.”18 That is where we will begin.

The ACA defines an American health benefit exchange in two places. First, section 1311(b)(1) of the Patient Protection and Affordable Care Act of 2010 (PPACA) says that “Each State shall, not later than January 1, 2014, establish an American Health Benefit Exchange (referred to in this title as an ‘Exchange’) for the State. . . .”19 Section 1311(d)(1) defines an exchange as “a governmental agency or nonprofit entity that is established by a State.”20 This is the only definition of exchange given in Title I of the PPACA, which also includes the provisions creating the new premium tax credits and cost-sharing subsidies.21

Second, the conforming amendments to the Public Health Service Act contained in PPACA section 1563(b)

13Scalia and Garner, Reading Law: The Interpretation of Legal Texts (2012). Reading Law makes a number of strong normative arguments, explicitly and implicitly, that we do not necessarily agree with. In fact, in many cases we disagree. See William N. Eskridge Jr., “The New Textualism and Normative Canons,” 113 Colum. L. Rev. 531 (2013). Nevertheless, the book provides a tractable set of important canons that its authors argue should be the basis of the careful elucidation of legal texts, and it is in that spirit that we refer to them.
14See, e.g., Scalia and Garner, supra note 13, at 20, 30. See also Canon 2 (“Supremacy-of-Text Principle”), supra note 13. All further references to “Canons” are to the respective canons in Scalia and Garner.
15See Adler and Cannon, supra note 6, at 142.
16See IRC section 36B(g).
17Treasury, IRS, “Health Insurance Premium Tax Credit,” 76 Fed. Reg. 50,935 (Aug. 17, 2011). For disclosure, one of us (Gamage) worked on this regulation while serving as special counsel and Senior Stanley S. Surrey Fellow at the U.S. Department of the Treasury, Office of Tax Policy, from 2010 through 2012.
18See Scalia and Garner, supra note 13, at 225 (Canon 36, “Interpretive-Direction Canon”).
19PPACA section 1311(b)(1).
20Id. at section 1311(d)(1).
21Id. at sections 1401-1402.
define exchange as “an American Health Benefit Exchange established under Section 1311 of the Patient Protection and Affordable Care Act.”

22 This definition thus refers back to the one cited above, meaning again that an exchange is “a government agency or nonprofit entity that is established by a State” under PPACA section 1311.

Thus, the only definitions that the ACA provides for the term “exchange” specify that an exchange must be established by a state. How then can HHS establish an exchange on behalf of states that decide not to create an exchange on their own? The answer comes from PPACA section 1321(c), which provides that if a state does not establish an exchange, then “the Secretary [of HHS] shall (directly or through an agreement with a not-for-profit entity) establish and operate such Exchange within the State and the Secretary shall take such actions as are necessary to implement such other requirements.”

Beyond the passages quoted above, the ACA does not contain any other definitions for an HHS-established exchange, for a federal exchange, or for anything other than an “exchange” — which, as defined, must be established by a state. 23 Taken literally, of course, HHS cannot possibly establish an exchange if the definition requires that an exchange be established by a state. But the wording of PPACA section 1321(c) stating that the secretary of HHS shall establish and operate “such Exchange” presumably means that section 1311(d)(1)’s requirement that an exchange must be established by a state does not apply in the case in which HHS establishes such exchange. Therefore, section 1321(c) can only be interpreted as instructing HHS to step into the shoes of the states that do not establish exchanges in order to establish exchanges on behalf of those states, or as otherwise designating HHS-established exchanges as having been established by a state. Indeed, even Adler and Cannon do not appear to doubt that the federal government can establish an exchange. 24

Returning to our canons, this is therefore a case in which a definition section is insufficient on its own and must be supplemented by other canons, 25 and in particular to the presumption against ineffectiveness and absurd results. 26 The surplusage canon is of no use. 27 This is because the phrase “established by a State” cannot be interpreted as anything but an illustration of what was expected to be the usual method of exchange establishment, at least when one considers the clear direction that the federal government establish exchanges when states choose not to do so.

It is important to note that the ACA contains many other indications that this is not a statute in which the surplusage canon should reign supreme. For example, “the ACA contains three sections with the same number (1563) and amends an existing provision of the Public Health Service Act inconsistently twice within the scope of a few pages.” 28 The ACA is thus hardly a model of legislative drafting; and it is ultimately not possible to interpret the ACA so as to give meaning and purpose to every term and reference.

B. Tax Credits Authorized by Section 1401 of the PPACA

With this background, we can analyze Adler and Cannon’s argument. PPACA section 1401 authorizes the new premium tax credits by adding section 36B to the Internal Revenue Code. In several places, section 1401 states that to be eligible for premium tax credits a taxpayer must enroll in a qualified health plan offered “through an Exchange established by the State under 1311” of the PPACA. 29

Adler and Cannon argue that this language means that premium tax credits are not authorized for health plans offered through HHS-established exchanges. They claim that the language of IRC section 36B contains two limiting phrases — “established by the State” and “under [Section] 1311.” Adler and Cannon contend that HHS-established exchanges are (a) not established by a state, and (b) are established under PPACA section 1321 rather than under section 1311. 30 Permitting tax credits on a federal exchange, they argue, would render both of these limiting phrases mere surplusage. Thus, in the context of section 1401, Adler and Cannon reject the interpretation of these phrases as illustrative and insist that they be given independent consequence. 31

We will begin by analyzing Adler and Cannon’s second claim that HHS-established exchanges are not established under PPACA section 1311. It is certainly true that without section 1321 of the PPACA, HHS would lack the authority to establish an exchange. However, it is also the case that PPACA section 1321 does not, on its own, grant HHS the authority to establish an exchange — section 1321 only creates such authority through its linkages to section 1311.

Specifically, section 1321 says that if a state chooses not to establish an exchange, 32 or fails to meet the requirements

22 Id. at section 1562(b).
23 Id. at section 1311(d)(1).
24 See Adler and Cannon, supra note 6, at 144.
25 See Scalia and Garner, supra note 13, at 228.
26 See Canons 4 (“Presumption Against Ineffectiveness”) and 37 (“Absurdity Doctrine”).
27 See Canon 26 ("Surplusage Canon").
28 Jost, supra note 12.
29 E.g., IRC section 36B(b)(2)(A).
30 See Adler and Cannon, supra note 6, at 144-145.
31 The phrase “established by the State under 1311” is actually itself largely redundant. Adler and Cannon interpret the repetition as demonstrating that Congress really meant this language to be limiting. Yet one might also interpret the use of this redundancy as another indication that only mischief will ensue if every turn of phrase in the ACA must be given independent force. Cf. Scalia and Garner, supra note 13, at 177.
32 PPACA section 1321(c)(1)(A).
of making an exchange operational, then HHS shall “establish and operate such Exchange within the State.” There is no further elaboration on what is meant by “such Exchange.” Thus, the only plausible interpretation is that HHS is empowered to establish an exchange as defined in section 1311, which it accomplishes by acting in the place of the state that fails to do so — in effect, by stepping into the shoes of that state. This is the only plausible interpretation because section 1311 is the only section of the ACA that specifies what an exchange is.

We thus have two possible interpretations of the language of IRC section 36B referring to an exchange “established . . . under 1311.” Adler and Cannon’s interpretation is that this language is meant to preclude exchanges established under sections 1321 and 1311 operating together. Our interpretation is that this language is meant to include exchanges established under sections 1321 and 1311 operating together. We will analyze the relative merits of these two interpretations after explaining Adler and Cannon’s other alleged “limiting phrase.”

In addition to the phrase “established under 1311” in IRC section 36B, Adler and Cannon claim the phrase “established by a State” clearly precludes HHS-established exchanges. However, as we have already explained, the ACA’s only definition of exchange specifies that all exchanges be established by a state. Again, section 1321 on its own does not provide any authority for HHS to establish an exchange, but only says that if a state fails to establish an exchange under section 1311, HHS shall establish such exchange. This language only makes sense if we interpret the ACA as authorizing HHS to step into the shoes of states that fail to establish exchanges in order to establish exchanges on their behalf.

Thus, there are two possible interpretations of section 36B. Adler and Cannon’s interpretation is that the phrase “established by a State” precludes HHS-established exchanges. Our interpretation is that HHS-established exchanges are effectively deemed to be established by a state through the linkages between section 1321 and section 1311 and because all exchanges in the ACA are defined as established by a state under section 1311(d)(1) and section 1563(b).

C. The Rest of the PPACA

In weighing the merits of Adler and Cannon’s interpretation against our own, we should examine the various ways in which the ACA refers to exchanges. Again, Adler and Cannon put great weight on the surplusage canon, ignoring the various textual indications that this canon might not be controlling in this situation, including with regard to the very word “exchange.” Different provisions of the ACA use a variety of terms in referring to exchanges, including “American Health Benefit Exchanges,” “State Exchanges,” “Exchanges established under this title,” “Exchange established under section 1311,” and “Exchanges established by the State under 1311.” Adler and Cannon’s argument is based on the notion that the use of different terms to refer to exchanges by different provisions is purposeful and meaningful. Yet we can discern no pattern in the use of these phrases.

Consider for example PPACA section 1312(f)(1), which states that only individuals who “reside in the State that established the Exchange” are qualified to purchase health insurance from the exchange. Seen from Adler and Cannon’s perspective, this language would preclude anyone from purchasing health insurance from HHS-established exchanges, because Adler and Cannon would hold that these exchanges were not established by the state. In an earlier version of their article, Adler and Cannon accept that this result does in fact follow from their method, but they argue that this result can be dismissed as absurd while still applying their method to provisions in which the result would not be absurd. In contrast, our interpretation of section 1321, whereby HHS-established exchanges are effectively deemed to be section 1311 exchanges, avoids this absurdity.

Consider another example. Section 1004 of the Health Care and Education Reconciliation Act of 2010 refers to exchanges established by section 1311 (that is, by a state) and section 1321 (that is, by HHS). This would seem to indicate, and Adler and Cannon insist that it does indicate, that Congress knew how to specifically refer to both kinds of exchanges.

**References**

33. Id. at section 1321(c)(1)(B).

34. There are other provisions that, like section 1321, specify types of exchanges or features related to exchanges, but that, like section 1321, operate through linkages to section 1311 and would not have meaning in its absence.

35. PPACA section 1311.
exchanges. However, section 1004 imposes various reporting requirements on exchanges in connection with tax credits, including the “aggregate amount of any advance payment of such credit.” This information is to be provided to HHS and to the taxpayer. Why would the statute go out of its way to require reporting about a credit that, on Adler and Cannon’s reading, cannot be granted on federal exchanges? Adler and Cannon assert it was just easier to have one reporting requirement, and telling taxpayers what they do not have is a useful way of encouraging states to establish exchanges. We think this explanation is not a fair reading of the statute. Any provision that puts into place a large reporting infrastructure should be presumed to have meant to report something significant.

Here is another similar riddle involving reporting: PPACA section 6005 requires some disclosures of information for an organization that provides “pharmacy benefit management services” to an “exchange established by a State under section 1311” (or another entity not relevant here). Does this limiting language mean that such an organization need not provide these disclosures, such as “the percentage of prescriptions for which a generic drug was available and dispensed,” if it contracts with a federal exchange? Why would this information be less important in connection with federal exchanges?

There are other related internal indicators that tax credits for individuals are available on federal exchanges. A particularly important example is the way in which the Act establishes Small Business Health Options Program (SHOP) exchanges. These exchanges are supposed to be one-stop shops for the employees of small businesses to purchase insurance, just as the exchanges we have been discussing to this point are meant to be one-stop shops for all other individuals to purchase insurance. And, as in the individual marketplace, individuals are to be encouraged to purchase insurance through these exchanges by means of tax credits.

SHOP exchanges are established by the same provision as the individual exchanges. Indeed, the states are permitted to merge their individual exchanges with their SHOP exchanges. PPACA section 1421 authorizes tax credits to be used on SHOP exchanges, just as section 1401 establishes individual tax credits. The credit provisions have interlocking definitions and similar structures, including progressive phaseouts. Treasury is given the authority to interpret both provisions. The structure of the PPACA therefore indicates that the two kinds of exchanges are to be interpreted symmetrically.

However, the authorization for the use of tax credits on a SHOP exchange uses the phrase “an Exchange” in multiple places — without further qualification. Sticking to the anti-surplusage canon here would presumably mean that the employees of small businesses in states with a federal exchange can receive credits, while the unemployed, the self-employed, or those employed by large employers cannot. Adler and Cannon seemingly embrace this result. Indeed, they view this result as evidence that Congress clearly knew how to use the unrestricted word “exchange” when it wished to do so. But again, this analysis seems to get matters backward. What discernable purpose could this distinction have?

Is there any other indication in the text that the PPACA wanted there to be this kind of distinction? Congress specifically allowed both kinds of exchanges to be merged. Over-reliance on this one canon creates absurd disjunctions that violate the canons concerning making the statute more effective (Canon 4) and harmonious (Canon 27).

D. Conclusion

Adler and Cannon would have a strong argument if the ACA had been written so that section 1321 contained its own definition of an exchange, or if section 1321 included language indicating that HHS-established exchanges were meant to be different from exchanges as defined in section 1311. But this is not how the statute was written. Instead, section 1321 says only that HHS shall establish “such Exchange[s].” Adler and Cannon’s interpretation requires that such exchanges be distinct in nature from the definition of exchange provided in section 1311, despite the fact that the ACA consistently used “established by a State” or “under Section 1311” as words of limitation. As to at least one key question — whether the federal government can establish an exchange at all — Adler and Cannon concede that these phrases cannot be taken as absolutely limiting and must therefore be illustrative. On another important question —

43 Adler and Cannon, supra note 6, at 161-162.
44 See Canon 4 (“Presumption Against Ineffectiveness”).
45PPACA section 1(b)(B).
46 Id. at section 1311(b)(2).
47 See, e.g., IRC section 45R(b)(1) (“qualified health plan” central to measuring size of SHOP credit); section 36B(b)(2)(A) (also using “qualified health plan” for measurement of individual credit); section 36B(c)(3)(A) (defining “qualified health plan” by reference to PPACA section 1301(a)); see also section 45R(c) (average wages one way that SHOP credits phase out); and section 36B(b)(3)(A) (value of individual credit phases out with household income).
48IRC section 36B(g); section 45R(i).
49 Adler and Cannon offer an explanation, based primarily on legislative history, for why the PPACA might have deliberately made federal exchanges less attractive: a desire to convince the states to start their own exchanges. But this explanation fails to address why the PPACA would want to distinguish the two types of exchanges (individual and SHOP) in this way. We also do not agree that the legislative history indicates that tax credits were not to be made available on federal exchanges. See Gluck, supra note 12.
50PPACA section 1562(b).
whether individuals could ever purchase insurance from a federal exchange — we assume that Adler and Cannon would concede that over-reliance on the anti-surplusage canon is likewise inappropriate.

As for other seeming anomalies caused by insistence on this one canon, our sense is that Adler and Cannon accept the results. Thus, on their reading of the ACA, only small business employees are eligible for credits on federal exchanges, the federal exchanges must report on the credits they have not provided, and some important information about prescription drug costs need not be reported to federal exchanges. We do not know why these results, either individually or in the aggregate, do not qualify as absurd. Or, put another way, we do not know what textual warrant permits Adler and Cannon to read the "established by a State" clause sometimes as a limitation and sometimes as an illustration.

On balance, we think the much better interpretation of the text of the ACA is that HHS-established exchanges qualify under the general definition of an exchange provided in section 1311 and are therefore effectively deemed to be established by the state on behalf of which HHS is acting. This interpretation maximizes the harmonious functioning of the whole statute, is grounded on the only definition of the word "exchange" present in the ACA, and does not require ad hoc picking and choosing regarding the importance of the phrase "established by a State." In so arguing, we are mindful of the importance of the non-surplusage canon, but also of the fact that, as Scalia and Garner warn, no canon is absolute. In this case, other weighty canons yield better results. In particular, we have appealed to the presumption against ineffectiveness, the whole text canon, the harmonious reading canon, and the absurdity doctrine canon.

We do not mean to suggest that Adler and Cannon’s interpretation is completely implausible, just that there is a better interpretation. At the very least, we believe we have established that the statute is ambiguous on this issue and that Treasury and the IRS have arrived at a reasonable interpretation worthy of deference.

51 See Canon 3 ("Principle of Interrelating Canons").
52 See Canon 4 ("Presumption Against Ineffectiveness").
53 Canon 24 ("Whole-Text Canon").
54 Canon 27 ("Harmonious-Reading Canon").
55 Canon 37 ("Absurdity Doctrine").
56 See Gluck, supra note 12.