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The Obamacare Reporting Loophole
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In many areas of the tax system, loopholes create horizontal inequity in that two nearly identical people pay very different taxes for trivial differences in behavior. Tax schemes for the financially sophisticated abound, such as paying mortgages early, converting 401k funds, and even dodging death taxes.

Obamacare provides a particularly egregious loophole for reporting income. It is a very lucrative yet an unintended scheme. Despite Sen. Orrin Hatch calling it a "fraudster's dream come true" back in 2013, the loophole still exists today.

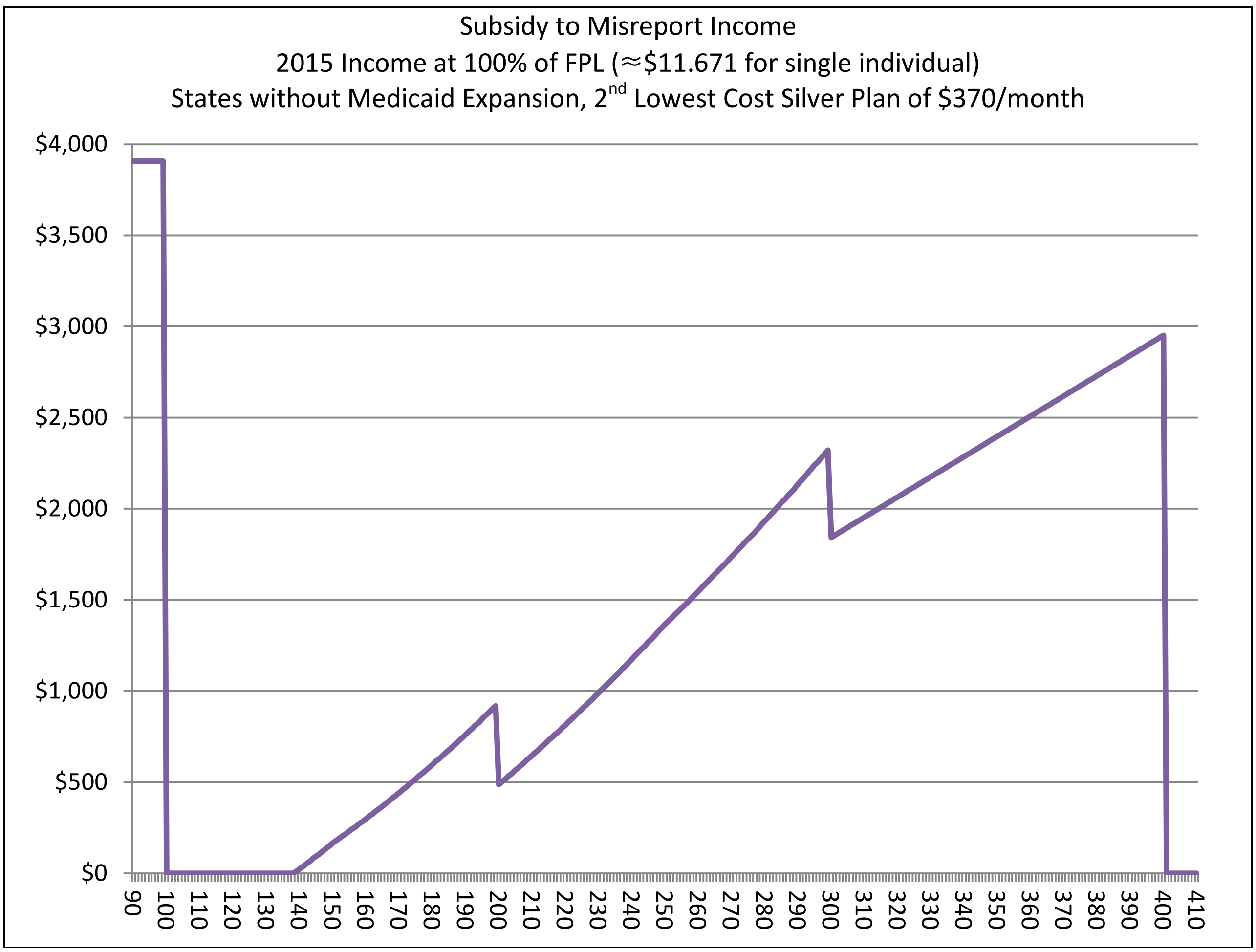
To illustrate the Obamacare reporting loophole, consider the health insurance marketplace in Hialeah, Florida with two consumers. The first, Michael, is single, age 49, a non-smoker, and makes $46,000. The second, Lisa, makes $47,000 but is otherwise similar. Both find themselves ineligible for a taxpayer subsidy on HealthCare.gov and in searching more than 80 plans decide on a Humana Bronze plan with an annual premium of $4,092.

Where's the reporting loophole? If Michael reports that he expects to make just $12,000 during 2015, he'll ultimately pay $1,250 for his health insurance. If Lisa does the same, she'll be on the hook for full amount. The Obamacare reporting loophole lowers Michael's payment by more than $2,800, even though he wasn't eligible for a taxpayer subsidy at all.

How does Michael profit from this? Obamacare offers sizable taxpayer subsidies to those with low income. Even so, many would have difficulty paying more than $4,000 in advance for health insurance. Instead, consumers can report their anticipated income and then have the subsidy advanced directly to the insurance company. Advanced reporting of income runs into a practical issue: Michael or Lisa might make an inaccurate report. If so, the advance subsidy would be incorrect. One might expect that Michael or Lisa would have to square up during tax filing season, a process the IRS calls reconciling.

For single individuals like Michael with income under $46,680 (400% of the poverty line), the way in which the advance subsidy is reconciled encourages misreporting. Michael faces a repayment limit of at most $1,250, if the taxpayer advance to the insurance company was too large. In contrast, there is no upper limit on repayment for Lisa, because her income is above 400% of the poverty line.

The graph below shows how Michael or Lisa profit purely from misreporting, as income changes in relation to the poverty line. In technical terms, if the unsubsidized cost of the second lowest-cost silver plan for an individual exceeds $370 per month in 2015, the Obamacare reporting loophole can lead to misreporting subsidies of nearly $3,000. Similar incentives exist for married couples, but with different thresholds and amounts.



What can be done about this loophole? Misreporting arises because repayments are capped. Those above 400% of the poverty line have no incentive to misreport because they would have to fully repay the advance. Aligning incentives to report with actual income by uncapping repayments, as is done for those over 400% of poverty, would remove this loophole. As consumers, financial advisors, and healthcare navigators learn about the Obamacare misreporting loophole, it will be tempting for many people to abuse it, ultimately harming taxpayers.

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