Issue Brief

FEDERAL ISSUE BRIEF

Analysis provided for MHA by Larry Goldberg, Goldberg Consulting

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CMS Issues Proposed Rule to Close a Health Care-Related Tax Loophole

The Centers for Medicare and Medicaid Services (CMS) have released a proposed rule to "Preserve Medicaid Funding for Vulnerable Populations -Closing a Health Care-Related Tax Loophole."

A copy of the 71-page document is currently on public display at the ***Federal Register*** office and is scheduled for publication on May 15.

The display version is available at: https://public-inspection.federalregister.gov/2025-08566.pdf.

A 60-day comment period is provided.

The proposed rule is intended to address a loophole in a regulatory statistical test applied to State proposals for Medicaid tax waivers. The test is designed to ensure, as required by statute, that non-uniform or non-broad-based health care-related taxes, authorized under a waiver, are generally redistributive. The inadvertent loophole currently allows some health care related taxes, especially taxes on managed care organizations, to be imposed at higher tax rates on Medicaid taxable units than non-Medicaid taxable units, contrary to statutory and regulatory intent for health care-related taxes to be generally redistributive.

Section 1903(w)(3)(E) of the Act states that the Secretary shall approve a health care-related tax waiver for the broad-based and/or uniformity requirements if the net impact of the tax and associated expenditures is "generally redistributive" in nature and the amount of the tax is not directly correlated to Medicaid payments for items and services with respect to which the tax is imposed.

If a State is seeking a waiver of the broad-based requirement for its health care-related tax, the tax must comply with § 433.68(e)(1) to be considered generally redistributive, which establishes the test known as the P1/P2 test. If the State seeks a waiver of the uniformity requirement, whether or not the tax is broad-based, the tax must comply with § 433.68(e)(2) to be generally redistributive, which establishes the test known as the B1/B2 test. These tests, where applicable, are intended to demonstrate that the State's tax program does not impose a higher tax burden on the Medicaid program compared to a broad-based and uniform tax.

CMS says it has found that States can manipulate B2 by excluding from the tax a few larger providers with much higher Medicaid taxable units than the average provider in the taxable universe. Doing so drastically affects the B-coefficient value for B2. Therefore, because the Medicaid taxable units are not evenly distributed among all providers, States can effectively charge higher rates on the remaining Medicaid taxable units that make up most of the tax without running afoul of the B1/B2 test.

CMS also says that there are several other mechanisms that States have used to undermine the efficacy of the B1/B2 test. Some States create tax programs with extraordinary differences in tax rates within a provider class based on taxpayer mix of Medicaid taxable units versus non-Medicaid taxable units.

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Before Federal fiscal year (FFY) 2024, CMS was aware of five States with six taxes that exploited the statistical loophole. The estimated total dollar revenue collected by States related to these taxes at that time was approximately $20.5 billion annually. In FFY 2025, CMS approved two additional States' Managed Care Organizations (MCO) tax waiver proposals that exploit the statistical loophole that total $3.5 billion in estimated tax revenue for the States. CMS estimates the total tax collection by 7 States for all taxes that exploit the loophole currently is approximately $23.6 billion per year.

CMS proposes to add new paragraph § 433.68(e)(3), to ensure that a health care-related tax is generally redistributive by preventing taxes that impose higher tax rates on providers that primarily serve Medicaid beneficiaries than on other providers that serve a relatively smaller number of such beneficiaries. Specifically, at paragraph (e)(3), CMS proposes that the new requirements would apply on a per class basis. CMS also proposes that regardless of whether a tax meets the standards in paragraph (e)(1) and (e)(2) the tax would not be "generally redistributive" if it has certain described attributes that are contrary to the tax program being generally redistributive in nature.

Current loophole taxes generate $23.6 billion in revenue. CMS estimates that closing the loophole now, before any additional states adopt this scheme, if the rule is finalized as proposed, will save the federal government over $33 billion over the next 5 years. If just two more states adopted this model each year, CMS estimates that excess federal costs could balloon more than $74 billion over 5 years.

Comment

CMS has not identified the 7 states.