

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**OHIO'S AND MICHIGAN'S SALES AND USE
TAXES ON MEDICAID MANAGED CARE
ORGANIZATION SERVICES DID NOT
MEET THE BROAD-BASED
REQUIREMENT BUT ARE NOW IN
COMPLIANCE**

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April 2017
A-03-16-00200

Office of Inspector General

<https://oig.hhs.gov>

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OFFICE OF AUDIT SERVICES FINDINGS AND OPINIONS

The designation of financial or management practices as questionable, a recommendation for the disallowance of costs incurred or claimed, and any other conclusions and recommendations in this report represent the findings and opinions of OAS. Authorized officials of the HHS operating divisions will make final determination on these matters.

Report in Brief

Date: April 2017

Report No. A-03-16-00200

U.S. DEPARTMENT OF HEALTH & HUMAN SERVICES
OFFICE OF INSPECTOR GENERAL



Why OIG Did This Review

In July 2014, the Centers for Medicare & Medicaid Services (CMS) issued a State Health Official Letter to State Medicaid Directors and State Health Officials to clarify the requirements of the Deficit Reduction Act of 2005 (DRA) which required States to discontinue Medicaid managed care organization (MCO) only taxes by October 1, 2009. The letter reminded States that if a State taxes MCOs, the tax must extend to both Medicaid and non-Medicaid MCOs (i.e., be broad-based) to comply with Federal requirements.

The objective of this review was to determine whether States' taxation of MCO services met Federal requirements that such health-care-related taxes be broad based.

How OIG Did This Review

Our review covered eight States (California, Georgia, Kentucky, Michigan, Missouri, Ohio, Oregon, and Pennsylvania) that the National Conference of State Legislatures identified as continuing to tax only Medicaid MCOs as of June 2009. We analyzed the Federal requirements concerning States' taxation of MCOs and confirmed with each State's officials their State's requirements governing health-care-related taxes and how those requirements related to MCOs. We reviewed statutes and regulations from the eight States to determine their taxation of MCOs and their compliance with Federal requirements.

Ohio's and Michigan's Sales and Use Taxes on Medicaid Managed Care Organization Services Did Not Meet The Broad-Based Requirement But Are Now in Compliance

What OIG Found

At the time of our audit in 2016, two States did not meet Federal requirements stating that taxes on MCOs be broad-based. Specifically, Ohio and Michigan continued to tax only Medicaid MCOs under their sales and use tax programs. Ohio stated that it would work with CMS to address changes that might need to be made to its tax.

Two States, California and Pennsylvania, implemented new MCO tax programs effective July 1, 2016, to conform to the DRA. Four States (Georgia, Kentucky, Missouri, and Oregon) discontinued collecting their Medicaid MCO-only tax on September 30, 2009, to conform to the DRA.

What OIG Recommends and CMS Comments

We recommended that CMS monitor Ohio's and Michigan's use of revenues from their sales and use tax on Medicaid MCOs as part of the State share of Medicaid program expenditures after December 31, 2016, and verify that they conform to Federal requirements that such taxes be broad based.

In written comments on our draft report, CMS concurred with our recommendation and stated that it granted Ohio a waiver that would bring the State's proposed MCO tax into compliance. The waiver is effective July 1, 2017. Michigan discontinued its tax on December 31, 2016, as scheduled and is now also in compliance. CMS also stated that it would continue to monitor both States to ensure that their health-care-related taxes are broad-based. Combined, Ohio and Michigan expect an estimated \$797 million decrease in Federal revenue in the first year after these changes go into effect.

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INTRODUCTION

WHY WE DID THIS REVIEW

On July 25, 2014, the Centers for Medicare & Medicaid Services (CMS) issued a State Health Official Letter (SHO #14-001) to State Medicaid Directors and State Health Officials to clarify the requirements of the Deficit Reduction Act of 2005 (DRA) concerning State taxation of managed care organizations (MCOs). SHO #14-001 required States to discontinue MCO-only taxes by October 1, 2009, and reminded States that if a State taxes MCOs, the tax must extend to both Medicaid and non-Medicaid MCOs (i.e., be broad based) to comply with Federal requirements. An Office of Inspector General (OIG) review of Pennsylvania's gross receipts tax on Medicaid MCOs highlighted concerns that SHO #14-001 addressed.¹

OBJECTIVE

The objective of this review was to determine whether States' taxation of MCO services met Federal requirements that such health-care-related taxes be broad based.

BACKGROUND

Medicaid Program

The Medicaid program provides medical assistance to low-income individuals and individuals with disabilities. The Federal and State Governments jointly fund and administer the Medicaid program. Each State administers its Medicaid program in accordance with a CMS-approved State plan. Although States have considerable flexibility in designing and operating their Medicaid program, each State must comply with applicable Federal requirements.

States may seek a waiver to implement managed care delivery programs (Social Security Act (the Act) § 1915(b)). The managed care programs are intended to increase Medicaid beneficiaries' access to and quality of care. States contract with MCOs to provide specific services to enrolled Medicaid beneficiaries, usually in return for a predetermined periodic payment known as a capitation payment.

Health-Care-Related Tax Requirements

Within certain limits, States are permitted to use revenues from health-care-related taxes to finance the State's share of Medicaid expenditures.² These health-care-related taxes:

- must be imposed on a permissible class of services,³

¹ *Pennsylvania's Gross Receipts Tax on Medicaid Managed Care Organizations Appears To Be an Impermissible Health-Care-Related Tax* (A-03-13-00201), published May 28, 2014.

² Section 1903(w) of the Act permits use of revenues from permissible health-care-related taxes. The implementing regulations for section 1903(w) can be found at 42 CFR part 433, subpart B.

- must be broad-based or apply to all services within a class,
- must be imposed at a uniform rate for all services within a class, and
- must not allow arrangements that return the collected taxes directly or indirectly to the taxpayer (hold-harmless arrangements).

Section 1903(w)(7)(A) of the Act, as amended by the Medicaid Voluntary Contribution and Provider-Specific Tax Amendments of 1991 (P.L. No. 102-234), and implementing regulations identify a number of classes of health care items and services upon which States can impose taxes consistent with other applicable requirements without affecting Federal matching funding (permissible classes).⁴ Included among those classes in the original enactment of that section were “services of health maintenance organizations (and other organizations with contracts under section 1903(m)).”

Health-Care-Related Taxation of Managed Care Organizations

Section 4701(a)(1)(A) of the Balanced Budget Act of 1997 (P.L. No. 105-33) changed the statutory terminology for Medicaid managed care, substituting the phrase “Medicaid managed care organizations” for the previously used “health maintenance organizations.” This narrowed the permissible class of services to services provided only to Medicaid beneficiaries and allowed States to impose taxes that burdened the Medicaid program only.

Section 6051 of the Deficit Reduction Act of 2005 (P.L. No. 109-171) revised section 1903(w)(7)(viii) of the Act to redefine this permissible class as services of MCOs (but not limited to Medicaid MCOs).⁵ This provision modified the definition of a broad-based tax for this class of providers and was implemented on October 1, 2009.⁶ After October 1, 2009, such taxes had to apply to all MCOs.

OIG Report on Pennsylvania’s Tax on Medicaid Managed Care Organizations

A previous OIG review found that a Pennsylvania Statewide gross receipts tax only on Medicaid MCOs appeared to be an impermissible health-care-related tax according to Federal requirements. In our review, we found that Pennsylvania applied a portion of what it collected from the tax to its share of Medicaid costs and, as a result, obtained nearly \$1 billion in Federal Medicaid funds from 2009 through 2012. We recommended that CMS clarify its policy concerning permissible health-care-related taxes.

³ A class is a type of health care service eligible for taxation.

⁴ 42 CFR § 433.56.

⁵ The amended section 1903(w)(7)(A)(viii) states that MCOs as a class include “health maintenance organizations, preferred provider organizations, and such other similar organizations as the Secretary may specify by regulation.”

⁶ 74 Fed. Reg. 31196, 31197 (June 30, 2009).

CMS Guidance on State Taxation of Managed Care Organizations

CMS issued SHO #14-001 in July 2014 to address CMS concerns that States were not complying with requirements of the Act as amended by the DRA and were still taxing only Medicaid MCOs. OIG's review of Pennsylvania's Statewide gross receipts tax highlighted these concerns. As articulated in SHO #14-001, Medicaid MCO-only taxes are not consistent with applicable statutory and regulatory requirements because they target Medicaid providers and treat those Medicaid providers differently than they treat other individuals or entities for purposes of the tax. CMS advised States with Medicaid MCO-only taxes to consider their current practices in light of this guidance and to make any changes necessary to achieve compliance by no later than the end of their next regular legislative session.

HOW WE CONDUCTED THIS REVIEW

Our review covered eight States (California, Georgia, Kentucky, Michigan, Missouri, Ohio, Oregon, and Pennsylvania) that the National Conference of State Legislatures identified as continuing to tax only Medicaid MCOs as of June 16, 2009.⁷ We analyzed the Federal requirements concerning States' taxation of MCOs and confirmed with each State's officials their State's requirements governing health-care-related taxes and how those requirements related to MCOs. We reviewed statutes and regulations from the eight States to determine their taxation of MCOs and their compliance with Federal requirements.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix A contains the details of our audit scope and methodology.

FINDINGS

At the time of our audit in 2016, two States did not meet Federal requirements that taxes on MCOs be broad based. Specifically, Ohio and Michigan continued to tax only Medicaid MCOs under their sales and use tax programs. Ohio stated that it would work with CMS to address changes that might need to be made to its tax. Michigan was scheduled to discontinue its tax on December 31, 2016. Two States, California and Pennsylvania, implemented new MCO tax programs effective July 1, 2016, to conform to the DRA. Four States (Georgia, Kentucky, Missouri, and Oregon) discontinued collecting their Medicaid MCO-only tax on September 30, 2009, to conform to the DRA. Subsequent to the release of our draft audit report, CMS granted Ohio a waiver that would bring the State's proposed MCO tax into compliance. The waiver is

⁷ National Conference of State Legislatures. "Health Care Provider and Industry Taxes and Fees, Updated August 2010." Available online at <http://leg.mt.gov/content/Publications/fiscal/Legislative-Options/September-2010/NCSL.pdf>. Accessed on September 10, 2010.

effective July 1, 2017. In addition, Michigan discontinued its tax on December 31, 2016, as scheduled and is now also in compliance.

FEDERAL REQUIREMENTS

Federal regulations specify the conditions under which revenue from a health-care-related tax may be used to finance the State's share of Medicaid expenditures. The tax must be imposed on a permissible class of services; be applied broadly or applied to all services within a class; be applied uniformly, so that all payers of the tax pay at the same rate; and avoid hold-harmless arrangements by which collected taxes are returned directly or indirectly to the taxpayers (42 CFR § 433.68(f)).

The Act and implementing regulations include MCO services as one of the specified classes of health care services on which States may impose a health-care-related tax. Section 6051 of the DRA revised section 1903(w)(7)(A)(viii) of the Act to redefine this permissible class as services of MCOs. It did not limit the class to Medicaid MCOs and thus required application of the tax to both Medicaid and non-Medicaid MCOs. CMS reminded States of the DRA changes in SHO #14-001 and advised them to make changes necessary to achieve compliance by no later than the end of their next legislative session.

TWO STATES CONTINUED MEDICAID MANAGED CARE ORGANIZATION-ONLY TAXES THROUGH 2016 BUT ARE NOW IN COMPLIANCE WITH THE BROAD-BASED REQUIREMENT

Ohio

From December 1, 2005, until September 30, 2009, Ohio taxed only its Medicaid MCOs under its franchise permit fee program. On October 1, 2009, Ohio ended the franchise permit fee on Medicaid MCOs to conform to DRA requirements but extended its sales and use tax to Medicaid MCOs.⁸ This tax is still in effect.

Ohio's next legislative session after CMS issued SHO #14-001 began January 5, 2015, and ended January 1, 2017. Ohio stated that it did not intend to end its sales and use tax on Medicaid MCOs by January 1, 2017, but that it would work with CMS to address changes that might need to be made to its tax. However, on December 7, 2016, after we issued our draft report, CMS approved a waiver for Ohio that would bring the State's proposed MCO tax into compliance.⁹ The waiver will go into effect July 1, 2017. Ohio estimated that Federal revenues would decrease \$193 million in the first year after the end of its Medicaid MCO-only tax program.

Michigan

In State fiscal year 2002–2003, Michigan instituted a tax on capitation premiums for only Medicaid MCOs under its quality assurance assessment program. This tax was rescinded on

⁸ Ohio Revised Code § 5739.01(B)(11)(a).

⁹ CMS's approval of the waiver was contingent on Ohio meeting certain technical requirements.

April 1, 2009. From April 1, 2009, through March 31, 2012, Michigan taxed only Medicaid MCOs under its sales and use tax. This tax was discontinued on April 1, 2012. However, Michigan once again began taxing Medicaid MCOs under the sales and use tax on April 1, 2014. The sales and use tax ended on December 31, 2016, which brings Michigan into compliance with Federal requirements. Michigan estimated that Federal revenues would decrease by \$604 million in the first year after the expiration of the Medicaid MCO-only tax. To help offset this loss, Michigan increased its Health Insurance Claims Assessment (HICA)¹⁰ tax rate from 0.75% to 1.0% on January 1, 2017.

TWO STATES DISCONTINUED MEDICAID MANAGED CARE ORGANIZATION-ONLY TAXES IN 2016

California

California imposed a quality and improvement fee on the total operating revenue¹¹ of MCOs in Medi-Cal, California's Medicaid program, beginning January 1, 2005.¹² This tax remained in effect until October 1, 2009. On July 1, 2010, California initiated a tax on the gross premiums of Medi-Cal MCOs.¹³ This tax remained in effect until July 1, 2016. In July 2013, California extended its sales tax to include Medi-Cal MCOs' gross receipts. This tax ended as of June 30, 2016.¹⁴

California's next legislative session after CMS issued SHO #14-001 began December 1, 2014, and adjourned September 11, 2015. However, a special session to address health care spending issues began June 19, 2015, and ended March 10, 2016. On March 1, 2016, California's Governor signed a bill establishing applicable taxing tiers and per enrollee amounts for the 2016–17, 2017–18, and 2018–19 fiscal years for Medi-Cal enrollees, Alternate Health Care Service Plan enrollees, and other enrollees.¹⁵ The approved legislation was effective July 1, 2016, but required CMS approval because California needed a waiver from the broad-based tax and uniform tax requirements.¹⁶ CMS approved California's waiver on May 17, 2016.

¹⁰ HICA is a broad-based tax on all claims paid by Michigan health insurers, except Medicare and veterans' claims, which are exempt from the tax.

¹¹ Total operating revenue means non-Medicare amounts received by a managed care plan for the coverage or provision of all health care services.

¹² California Welfare and Institutions Code § 14464.5.

¹³ California Revenue and Taxation Code §§ 12201-12210.

¹⁴ California Revenue and Taxation Code §§ 6174-6189.

¹⁵ California Welfare and Institutions Code §§ 14199.50-56.

¹⁶ 42 CFR § 433.68(e)(2).

Pennsylvania

In July 2004, Pennsylvania implemented a health-care-related tax limited to the revenue of Medicaid MCOs.¹⁷ In September 2009, Pennsylvania discontinued that tax to conform to DRA requirements. Effective October 1, 2009, Pennsylvania extended its gross receipts tax to Medicaid MCOs.

Pennsylvania's next legislative session after CMS issued SHO #14-001 began January 5, 2015, and ended November 30, 2016. In December 2015, Pennsylvania's Governor signed a bill to repeal the gross receipts tax on Medicaid MCOs effective June 30, 2016, and impose a per member per month fixed fee on all MCOs (Medicaid and non-Medicaid) to conform to Federal requirements. The fixed fee is effective from July 1, 2016, through June 30, 2020.¹⁸

FOUR STATES DISCONTINUED COLLECTING MEDICAID MANAGED CARE ORGANIZATION-ONLY TAXES IN 2009

Georgia

Effective July 1, 2005, Georgia imposed a quality assessment fee on only Medicaid MCOs.¹⁹ Georgia did not officially rescind the quality assessment fee but stated it had reset the fee to 0 percent on October 1, 2009, in accordance with State code, which states, "The aggregate quality assessment fees imposed under this article shall not exceed the maximum amount that may be assessed pursuant to 42 C.F.R. Section 433.68(f)(3)(i)."²⁰ As long as this fee remains at 0 percent, Georgia will remain in compliance with Federal requirements.

Kentucky

Kentucky's legislature imposed a tax on the gross revenues received by Medicaid MCOs after July 1, 2005.²¹ This provision is still in effect. However, Kentucky stated that it had not collected the tax after September 30, 2009. Kentucky's Department of Revenue confirmed that Medicaid MCO provider tax collections ceased as of September 30, 2009, in accordance with Chapter 5, section 6051, of the DRA. As long as Kentucky continues not to collect this tax, it will remain in compliance with Federal requirements.

Missouri

Missouri imposed a Medicaid MCO reimbursement allowance tax on Medicaid MCO revenues starting July 1, 2005. The tax is still in effect and currently set to expire on

¹⁷ Pennsylvania Act 69-2004.

¹⁸ Pennsylvania Act 92-2015 § 801-I.

¹⁹ Official Code of Georgia § 31-8-170-177.

²⁰ Official Code of Georgia § 31-8-173.

²¹ Kentucky Revised Statutes § 142.316.

September 30, 2018.²² However, Missouri has not collected this tax since September 30, 2009. As long as Missouri continues not to collect this tax, it will remain in compliance with Federal requirements.

Oregon

Effective May 1, 2004, Oregon began taxing Medicaid MCOs' capitation payments.²³ The tax on Medicaid MCOs ended September 30, 2009, to conform to Federal requirements.²⁴ Oregon then enacted a broad-based assessment on capitation payments for all MCOs (Medicaid and non-Medicaid) in compliance with Federal requirements. This tax was in effect from October 1, 2009, through September 30, 2013.²⁵ Oregon did not tax MCOs after September 2013.

RECOMMENDATION

We recommend that CMS monitor Ohio's and Michigan's use of revenues from their sales and use tax on Medicaid MCOs as part of the State share of Medicaid program expenditures after December 31, 2016, and verify that they conform to Federal requirements that such taxes be broad based.

CMS COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE

In written comments on our draft report, CMS concurred with our recommendation and stated that it granted Ohio a waiver that would bring the State's proposed MCO tax into compliance. The waiver is effective July 1, 2017. CMS also stated that Michigan had recently discontinued its tax on MCOs. CMS stated that it would continue to monitor both States to ensure that their health-care-related taxes are broad based. Combined, Ohio and Michigan expect an estimated \$797 million decrease in Federal revenue in the first year after these changes go into effect.

CMS's comments are included as Appendix B, except for technical comments that we addressed as appropriate.

²² Missouri Revised Statutes § 208.437.1.

²³ Oregon Administrative Rules 410-050-0130.

²⁴ Oregon Administrative Rules 410-050-0240.

²⁵ Oregon Revised Statute §§ 743.960-.990.

APPENDIX A: AUDIT SCOPE AND METHODOLOGY

SCOPE

We reviewed the status of State tax programs that taxed Medicaid MCOs as of October 1, 2009, as identified by the National Conference of State Legislatures. California, Georgia, Kentucky, Michigan, Missouri, Ohio, Oregon, and Pennsylvania were the eight States identified.

We did not review the overall internal control structures of the States' Medicaid programs. We limited our review to determining whether these eight States were in compliance with Federal requirements concerning the taxation of MCOs. We did not extend our review to any other health-care-related tax programs in those eight States.

We conducted our audit from November 2015 through May 2016.

METHODOLOGY

To accomplish our objective, we:

- reviewed applicable Federal statutes, regulations, and guidance on permissible health-care-related taxes on MCOs;
- reviewed State statutes, regulations, and guidance related to taxation of MCOs in California, Georgia, Kentucky, Michigan, Missouri, Ohio, Oregon, and Pennsylvania and obtained confirmation from State Medicaid Officials in these States that this information was accurate and complete; and
- met with CMS officials to discuss our findings and recommendations.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

APPENDIX B: CMS COMMENTS



DEPARTMENT OF HEALTH & HUMAN SERVICES

Centers for Medicare & Medicaid Services

200 Independence Avenue SW
Washington, DC 20201

DATE: DEC 19 2016

TO: Daniel R. Levinson
Inspector General

FROM: Andrew M. Slavitt 
Acting Administrator

SUBJECT: Office of Inspector General (OIG) Draft Report: Ohio's and Michigan's Sales and Use Taxes of Medicaid Managed Care Organization Services Do Not Meet Broad-Based Requirements (A-03-16-00200)

The Centers for Medicare & Medicaid Services (CMS) appreciates the opportunity to review and comment on the Office of Inspector General's (OIG) draft report. CMS is committed to making sure that States fund their Medicaid programs through permissible sources.

Section 1903(w)(3)(A)(i) of the Social Security Act defines a health-care-related tax using multiple tests that must be applied. Health-care-related taxes include taxes related to: (1) health care items or services; (2) the provision of, or the authority to provide, the health care items or services; or (3) payment for such items or services. Section 1903(w)(3)(A)(ii) further stipulates that a health-care-related tax includes taxes that are not limited to health care items or services, but provide for different or unequal treatment for individuals or entities that are paying for or providing health care items or services. Any tax must be fully evaluated against all components of the statutory definition.

Previously, the Act provided that services of Medicaid managed care organizations (MCOs) as one of the classes of services upon which States can impose taxes. The Act was further amended to redefine this class of health care services as "services of managed care organization," essentially extending the class of service from Medicaid MCOs only to all MCOs. CMS issued guidance to states in July 2014 to clarify what would or would not be considered a health-care-related tax and in light of this guidance, advised states that may have non-permissible health-care-related taxes to make any changes necessary to achieve compliance as soon as feasible.

OIG's recommendation and CMS' response are below.

OIG Recommendation

We recommend that CMS monitor Ohio's and Michigan's use of revenues from their sales and use tax on Medicaid MCOs as part of the State share of Medicaid program expenditures after December 31, 2016, and verify that they conform to Federal requirements that such taxes be broad based.

CMS Response

CMS concurs with OIG's recommendation. Michigan has informed CMS that they have recently made the necessary changes through state legislation to end their current use of revenues sales and use tax on Medicaid Managed Care Organizations (MCOs). In addition, CMS recently approved Ohio's request for a waiver effective July 1, 2017, which would bring the state into compliance on its proposed MCO tax based on their ability to demonstrate that the proposed tax is generally redistributive. CMS will continue to monitor both States to verify compliance with Federal requirements that such taxes be broad based.

CMS appreciates OIG's input and feedback on states funding their Medicaid programs through permissible sources. We look forward to continue working with OIG on this issue and others in the future.