LAO
70 YEARS OF SERVICE

December 1, 2015

MCO Tax Overview

LEGISLATIVE ANALYST'S OFFICE

Presented to:
Conference Committee on SB X2 2 and AB X2 1,
Second Extraordinary Session

Hon. Ed Hernandez, Chair
Hon. Rob Bonta, Chair

LAO
70 YEARS OF SERVICE

Overview of Presentation

☑ **Managed Care Organization (MCO) Tax Background**

- Overview of health care-related taxes
- Waiving federal requirements for health care-related taxes
- California's current MCO tax

☑ **Overview of Two Potential Approaches to Restructuring MCO Tax**

- Governor's January proposal—a tiered tax
- Flat tax

☑ **Comparison Between Two Approaches**

- Revenue stability
- Industrywide and distributional impact on MCOs

LAO
70 YEARS OF SERVICE

Health Care-Related Taxes

☑ ***What Are Health Care-Related Taxes?*** Federal Medicaid law defines a *health care-related tax* as a licensing fee, assessment, or other mandatory payment that is related to the provision of or payment for health care services or items. In many cases, states collect these payments from health care providers to help finance the nonfederal share of their Medicaid expenditures.

☑ ***Federal Requirements for Health-Care Related Taxes.*** Health care-related taxes must meet three major requirements to be permissible under federal law. (Two of these requirements may be waived under certain conditions, as we describe next.)

Three Requirements for Health Care-Related Taxes

Broad-Based. The tax is broad-based if it is imposed on all providers within a specified class of providers.

Uniform. The tax is uniform if it is applied at the same rate for all payers of the tax.

No Hold Harmless. The state may not provide a direct or indirect guarantee that providers receive their tax payment back (or be "held harmless" from the tax).

LAO
70 YEARS OF SERVICE

Some Federal Requirements May Be Waived

☑ ***States Can Receive Waivers of Broad-Based and Uniform Requirements . . .*** Federal Medicaid rules permit some health care-related taxes that do not meet the strict definitions of *broad-based* and *uniform*. That is, some permissible taxes may be applied neither to all providers within a class, nor at the same rate across all taxed providers. To ensure such a tax is treated as permissible, a state must formally request the federal government to waive the broad-based and uniform requirements.

☑ ***. . . But Not the No-Hold-Harmless Requirement . . .*** Federal law does not allow for any waivers of the no-hold-harmless requirement.

☑ ***. . . And Only Without Lowering Relative Tax Burden for Non-Medicaid Providers.*** Within its waiver request, the state must demonstrate that its proposed tax structure would place a relative gross tax burden on non-Medicaid providers at least as great as under a broad-based and uniform tax. Therefore, if the state attempted to exempt *all* non-Medicaid providers from the tax, the tax would likely be denied federal approval.

LAO
70 YEARS OF SERVICE

California's Current MCO Tax

- ***Tax on MCOs' Revenues From Medi-Cal Managed Care.*** Chapter 33, of 2013 (SB 78, Committee on Budget and Fiscal Review) imposes a 3.9 percent tax on the total operating revenue received by MCOs through their Medi-Cal managed care plans.

- ***Does Not Create Net Benefit or Cost to MCOs.*** The current MCO tax is economically neutral to the MCOs paying the tax. At a high level, the tax can be thought of as financing the nonfederal share of Medi-Cal payments to MCOs, which are matched with enough federal funds to (1) hold MCOs harmless and (2) offset other General Fund costs.

- ***Is Likely Impermissible.*** Over half of the state's MCOs do not operate Medi-Cal managed care plans and therefore do not pay any MCO tax. Therefore, tax is likely impermissible under federal Medicaid requirements.

- ***May Jeopardize Federal Medicaid Funding if Continued in Current Form . . .*** In a July 2014 letter, the federal government clarified that health care-related taxes structured like California's current MCO tax are likely impermissible. If the MCO tax is extended in its current form past the federal government's deadline for states to reform their tax structures, California would risk the entire amount of federal Medicaid funds attached to the tax.

- ***. . . Though Not in 2015-16.*** The federal deadline to states to reform their tax structures is the end of states' legislative sessions—August 31, 2016 for California. The current MCO tax sunsets on July 1, 2016. Therefore, we believe the federal funds leveraged by the tax in 2015-16 are *not* at risk, even if the state took no further action to extend or modify the tax.

LAO
70 YEARS OF SERVICE

Overview of Two Potential Approaches to Restructuring MCO Tax

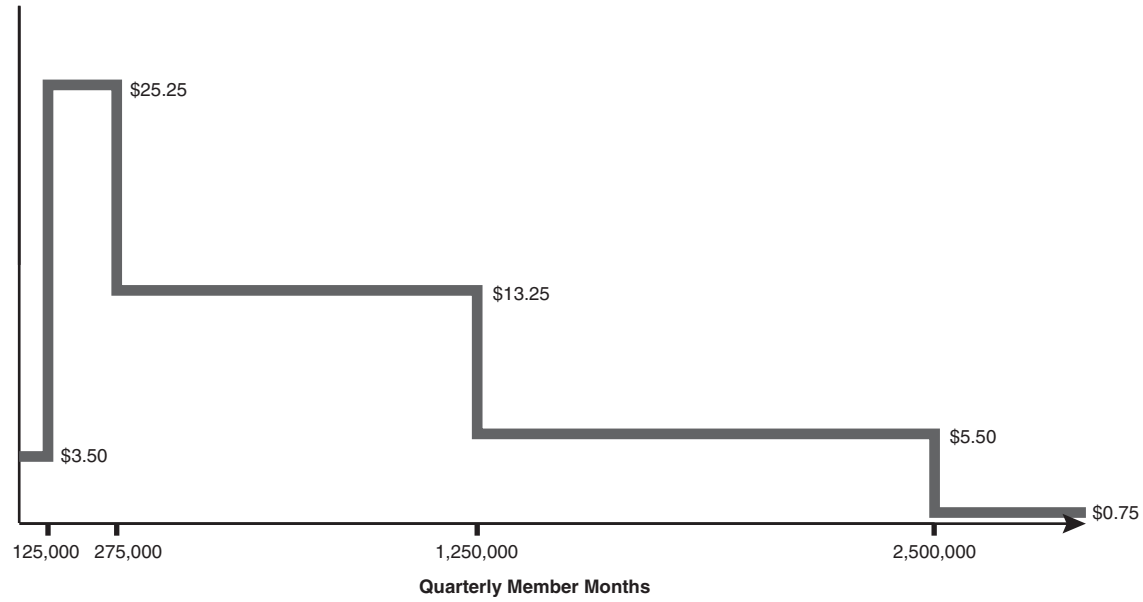
Since January, the Legislature has considered several proposals from the administration and others to restructure the MCO tax in a way that would be federally permissible and raise enough revenue to (1) maintain the General Fund offset from the current tax and (2) fund additional purposes. These proposals call for a *unit* tax based on each MCO's *enrollment*, rather than a percentage tax based on operating revenue.

☑ ***Governor's January Proposal—A Tiered Tax.*** The Governor's January budget proposed a *tiered* MCO tax structure based on enrollment size. The tax per unit (quarterly member months of enrollment) rises, then falls with increasing MCO enrollment. As an example, an MCO with 1 million taxable member months would pay $3.50 per unit for the first 125,000 member months, $25.25 per unit for the next 150,000 member months, and $13.75 per unit for the remaining 725,000 member months, resulting in a total payment of $14.2 million for the quarter. The figure below shows the tax tiers and the per unit tax amounts under the Governor's January proposal for 2015-16.

Overview of Two Potential Approaches to Restructuring MCO Tax *(Continued)*

Proposed Tiered Tax Per Additional Member Month in 2015-16

Tax Amount Per Additional Member Month



(We note the administration presented a modified proposal in September, which contained two different tiered structures as well as certain tax reductions and exemptions for specified MCOs. However, this presentation covers only the January version of the Governor's proposal.)

☑ ***One Alternative—A Flat Tax.*** Another approach the Legislature has considered is a *flat* tax structure that would impose a uniform tax on each MCO's member month, with the tax per member month not varying based on the total size of enrollment.

LAO
70 YEARS OF SERVICE

Commonalities and Differences Between Approaches

☑ ***Commonalities.*** As enrollment-based taxes, the two approaches share the following key characteristics.

- ***Tax Extended to Additional MCOs and Commercial Business.*** Under either approach, the state would impose the new tax on most MCOs that are licensed and regulated by the Department of Managed Health Care. This would expand the set of taxpayers to around 40 MCOs, compared to 25 MCOs that pay the current tax. Both approaches would impose the tax on each MCO's Medi-Cal *and* commercial enrollment.

- ***For Tax Paid on Medi-Cal Lives, State Can Hold MCOs Harmless . . .*** According to the administration, the state can build the cost of the tax—whether a tiered or flat structure—for each Medi-Cal enrollee into the MCOs' Medi-Cal managed care rates. This would effectively reimburse MCOs—and hold them harmless—for the portion of tax paid on Medi-Cal lives.

- ***. . . And Leverage Federal Funds.*** The federal government matches the above state reimbursements for the Medi-Cal portion of the tax, thereby providing additional funding for the state's use.

- ***Neither of the Above Is Possible for Tax Paid on Commercial Lives . . .*** For each member enrolled in commercial coverage, MCOs under either tax structure would owe tax, but could *not* be directly reimbursed for that tax due to federal restrictions. Because the state cannot provide Medi-Cal reimbursement for commercial tax payments, it cannot leverage federal funds through these payments.

LAO
70 YEARS OF SERVICE

Commonalities and Differences Between Approaches *(Continued)*

- ***. . . Meaning MCOs Would Likely Pass Tax Onto Commercial Purchasers.*** In economic terms, either a tiered or flat tax would function as an effective tax on MCOs' *commercial* coverage. In the long term, purchasers of commercial coverage—including the state as an employer—would likely bear some of the tax through higher premiums.

☑ ***Differences.*** The two approaches differ in the size and distribution of the net financial impact borne by MCOs, purely through the tax paid on commercial coverage. The remainder of this handout discusses the sources and potential consequences of these differences.

LAO
70 YEARS OF SERVICE

Revenue From Tiered Tax May Be Less Stable

Over time, the distribution of enrollment across MCOs may change for various reasons, such as MCO mergers and tax-induced market changes. The relevance of such shifts to federal permissibility and revenue-raising capacity varies greatly as between a tiered and flat tax.

☑ ***Federal Waiver Necessary for Tiered Tax.*** Because a tiered MCO tax is by definition non-uniform, a waiver would be necessary to implement this approach. The administration designed the tax tiers in the Governor's proposal to satisfy the waiver requirement, based on past *point-in-time* data on the distribution of MCO enrollment. Potentially, there could be a recurring need for the state to revise the tax tiers and resubmit them for federal approval in response to ongoing changes in the distribution of MCO enrollment. This would complicate the state's ability to effectively administer the tax.

☑ ***No Waiver Necessary for Flat Tax.*** A flat tax is by definition uniform, and would automatically satisfy the default federal requirements for a uniform tax structure. Under any enrollment scenario, there would be no need to obtain a waiver, and the flat tax would remain federally permissible, in terms of meeting the uniformity requirement.

☑ ***Total Tiered Tax Revenue Is Sensitive to Enrollment Shifts . . .*** MCO mergers and other market changes could lead to fewer and larger MCOs operating in the state. Under a tiered tax system based on enrollment size, these changes could also cause some MCOs to move between tax tiers. The amount of revenue raised by the tiered tax could be highly sensitive to such shifts.

LAO
70 YEARS OF SERVICE

Revenue From Tiered Tax May Be Less Stable *(Continued)*

☑ **. . . *While Total Flat Tax Revenue Is Insensitive to Enrollment Shifts.*** In contrast, holding *total* enrollment across the MCO industry constant, the total amount of revenue raised by a flat tax does not vary with the size or number of MCOs. This is because the uniform tax owed on any given enrollee would remain the same—regardless of whether that enrollee belonged to a small-, medium-, or large-sized MCO.

LAO
70 YEARS OF SERVICE

Example and Summary of Comparative Tax Burden

☑ ***An Example: Raising $1.36 Billion for the State's Use***

- ***Governor's January Proposal.*** The Governor's January proposal was designed to generate $1.36 billion for the state's use—$1.13 billion to maintain the General Fund offset from the current MCO tax, and $230 million to fund the In-Home Supportive Services service-hour restoration—at an annual net cost of $670 million to the MCO industry.
- ***Flat Tax.*** To generate the same state funding amount of $1.36 billion as the Governor's January proposal, a flat tax structure would require imposing a uniform tax of $5.66 per member-month. We estimate this flat structure would create a net industrywide liability of over $950 million.

☑ ***Bottom-Line Comparison.*** For a given funding target, compared to a flat tax, a tiered tax structured like the Governor's proposal—geared toward imposing the highest *gross* tax burden on the MCOs that participate most extensively in Medi-Cal—will result in a lower *net* financial impact to (1) the MCO industry *as a whole* and (2) the largest MCOs in particular. However, certain mid-sized MCOs with little or no Medi-Cal enrollment would owe more under a tiered tax.

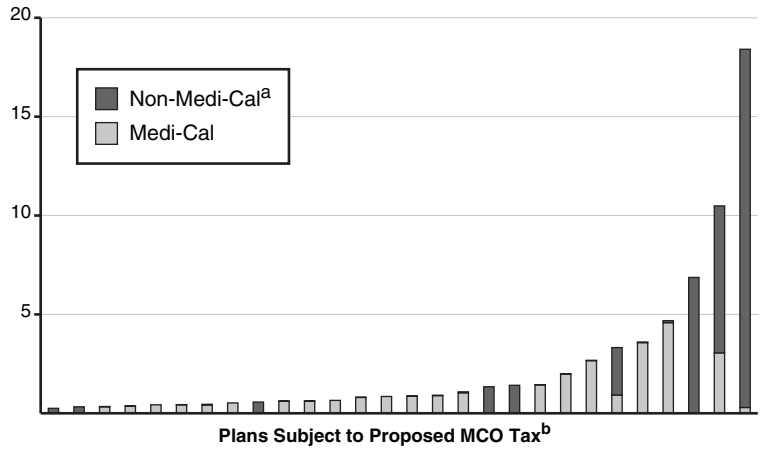
LAO
70 YEARS OF SERVICE

Tiered Tax Places Higher Burden on Certain Mid-Sized MCOs

☑ ***Tiered Tax Maximizes Federal Funds . . .*** Many MCOs that participate extensively in Medi-Cal managed care are mid-sized. A tiered tax structure is thus intended to place a greater share of the tax's *gross* burden on mid-sized MCOs, since much of their tax assessment would be related to Medi-Cal enrollees. As discussed earlier, the state can reimburse MCOs for taxes paid on Medi-Cal lives, which in turn leverages federal matching funds. The figure below shows the current distribution of plans subject to the Governor's proposed MCO tax, by size and Medi-Cal share of enrollment.

Distribution of MCOs by Size and Medi-Cal Share of Enrollment

Quarterly Member Months (In Millions)



[a] Excludes Medicare and plan-to-plan enrollment, which are exempt under proposed tax.

[b] Each column represents a different MCO's enrollment, as reported to the Department of Managed Health Care in the third quarter of 2014.

Note: Figure excludes 11 MCOs with fewer than 250,000 quarterly member months of enrollment.

MCO = managed care organization.

LAO
70 YEARS OF SERVICE

Tiered Tax Places Higher Burden on Certain Mid-Sized MCOs *(Continued)*

☑ **. . . *But Hits Certain Mid-Sized MCOs Hardest.*** Under the Governor's approach, some individual MCOs would face a disproportionate share of net tax liability for the following reasons.

- ***Low Medi-Cal Participation.*** These MCOs have little or no Medi-Cal enrollment, and therefore can receive little or no state reimbursement to offset their tax liability.
- ***Face Highest Tax Tiers.*** These MCOs are also mid-sized, meaning they have enough enrollment to be subject to the highest tax tiers, but not enough to reduce their average tax rates through the lowest tax tiers.

LAO
70 YEARS OF SERVICE

Flat Tax Places Higher Burden on Largest MCOs and Industry Overall

☑ ***Flat Tax Shifts Burden From Mid-Sized to Large MCOs—and Possibly the State.*** Because a $5.66 flat tax is substantially higher than the $0.75 large-sized tax tier under the Governor's January proposal, the state's largest MCOs would owe substantially more tax under a flat structure. As these MCOs provide most of the state's health coverage for workers and retirees, flattening the tax could result in greater costs being passed onto the state through employer health insurance premiums. The figure below compares the net tax liability for select MCOs under the Governor's January proposal versus a $5.66 flat tax alternative.

Tiered Versus Flat Structure: Comparing Net Impacts on Select MCOs

(In Millions)

	Net Liability—Tiered Tax[a]	Net Liability—Flat Tax[b]
Large MCOs		
MCO A	$24.3	$183.3
MCO B	118.4	210.3
MCO C	122.8	410.2
Mid-Sized MCOs With No Medi-Cal Enrollment		
MCO D	32.9	12.8
MCO E	14.4	5.7

[a] Assumes tax tiers under Governor's January proposal.
[b] Assumes $5.66 uniform tax per member-month.
MCO = managed care organization.

☑ ***Industrywide Burden Greater Under Flat Tax.*** In general, flattening the tax structure would reduce the individual net liability for the most disadvantaged mid-sized MCOs under the Governor's January proposal, but at a more-than-offsetting cost to the rest of the state's MCOs, creating a greater overall liability for the industry relative to the Governor's proposal.

LAO
70 YEARS OF SERVICE

Recap of Trade-Offs

Trade-Offs Between Tiered Versus Flat Structure

	Tiered Tax	Flat Tax
More Stable in Terms of . . .		
Federal permissibility		✓
Revenue predictability		✓
Minimizes Tax Burden On . . .		
Total MCO industry	✓	
Mid-sized MCOs with low Medi-Cal enrollment		✓
Large MCOs	✓	
State worker and retiree health benefits	✓	
Other Criteria		
Simpler to administer		✓
Maximizes federal funds	✓	
Minimizes unintended market consequences		✓

Note: For each criterion listed, the check mark indicates which of the two tax structures would generally perform better.

MCO = managed care organization.