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Proposed Rule on Medicaid Tax Waivers: CMS Moves to Close a Loophole Shifting Costs to the Federal Government

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On May 15, 2025, the Centers for Medicare & Medicaid Services ("CMS") released a proposed rule, entitled "Preserving Medicaid Funding for Vulnerable Populations – Closing a Health Care-Related Tax Loophole" to address a financing loophole that allows states to shift more Medicaid costs to the federal government than intended (the "Proposed Rule"). If finalized as proposed, states that received CMS-approved waivers for state healthcare-related taxes within the last year—including California, New York, Michigan, and Massachusetts—would be required to modify or eliminate those state taxes immediately or risk losing federal matching funds for expenditures paid using those tax revenues. Comments from stakeholders are due by July 14, 2025.

The major policy change in the Proposed Rule would eliminate an existing waiver process that allows states to obtain approval from CMS for certain health care-related taxes, which seven states, including California, New York, Michigan, and Massachusetts, have relied on to finance their share of Medicaid costs.

Under existing federal law and regulations, when a state imposes a tax on healthcare providers and uses the revenue to support Medicaid payments, the federal government provides matching funds, so long as the tax complies with specific statutory requirements set forth by Section 1903(w) of the Social Security Act.

To ensure that states are not simply recycling money back to taxed providers to draw down more federal funding, the law requires that health care-related taxes be broad-based, uniform, and not include "hold harmless" arrangements—where providers are effectively reimbursed for the taxes they pay. States can request a waiver from the "broad-based" and "uniform" requirements if they can show the tax is generally redistributive—i.e., it generally derives revenue from taxes on non-Medicaid services and uses them to finance the State's share of Medicaid payments for services. Since 1993, CMS has used specific statistical tests to assess whether a waiver-eligible tax is generally redistributive.

However, CMS is concerned that states have found ways to structure their taxes that technically pass the statistical test for a waiver of the "uniformity" requirement, but that actually impose more of the tax burden on Medicaid services than non-Medicaid services—such as by imposing higher tax rates on Medicaid services than on commercial services—and therefore are not "generally redistributive." CMS highlighted several examples of taxes imposed on managed care organizations (MCOs) where a disproportionate share of the tax burden is imposed on Medicaid member-months. CMS believes that these arrangements undermine the federal-state cost-sharing structure of Medicaid.

The Proposed Rule seeks to close this loophole by refining how CMS evaluates whether a health care-related tax is generally redistributive. It introduces more stringent requirements to ensure that taxes do not disproportionately target Medicaid providers and that the distribution of the tax burden reflects a true cross-section of the provider market. According to CMS, closing this loophole could save the federal government over $33 billion over five years.[1]

Specifically, CMS proposes to keep the two existing statistical tests for waivers of the broad-based and uniformity requirements, respectively, but to add new requirements that must be met even if the applicable statistical test(s) are satisfied. This represents a significant shift in CMS's approach, moving from a focus on statistical form to economic substance. Under the Proposed Rule, a tax that meets the applicable statistical tests still is not "generally redistributive" and will not be approved by CMS if: (i) the tax rate imposed on any taxpayer or taxpayer group based on its Medicaid taxable-units is higher than the tax rate imposed on non-Medicaid taxable units (e.g., an MCO tax where Medicaid member months are taxed at $200 per member-month and non-Medicaid member months are taxed at $20 per member month; (ii) the tax rate imposed on a taxpayer or taxpayer group that is defined based on its Medicaid volume or percentage is lower for the lower-Medicaid volume group and higher for the higher-Medicaid volume group (e.g., a higher tax rate for nursing facilities with a Medicaid inpatient utilization rate greater than 5% than the tax rate for nursing facilities with a Medicaid inpatient utilization rate less than 5%).

CMS explains that all seven of the existing approved State tax waivers would fail (i) and at least one existing State tax waiver would also fail (ii). CMS also proposes that any State tax that has the same effect as either (i) or (ii) – that is, where a State is using a substitute definition, measure, or attribute as a proxy for Medicaid to achieve the same effect—would not be generally redistributive and would not be approved.

To implement this change, CMS also proposes to define new terms for "Medicaid taxable unit" and "non-Medicaid taxable unit" to distinguish between units that the basis of Medicaid payment (like Medicaid bed-days, Medicaid revenues or Medicaid charges) or otherwise associated with the Medicaid program and units that are not associated with the Medicaid program. States may need to reassess how they define tax bases for taxpayers and classes of providers to ensure they do not disproportionately burden Medicaid utilization.

The Proposed Rule would provide a one-year transition period for any State tax that does not comply with the new requirements, but only if CMS approved the tax waiver more than two years prior to the effective date of any final rule. By contrast, state taxes that obtained waivers more recently (i.e., less than two years prior to the effective date of any final rule), such as California, Michigan, Massachusetts, and New York, would not be eligible for a transition period and would be required to comply with the new requirements as of the effective date of the final rule or risk a reduction in federal Medicaid funding.[2] With no transition period for recent waivers, states like New York may have as little as 60 days to comply after the final rule is published. States, their Medicaid agencies, and stakeholders should begin internal reviews now to avoid rushed changes to avoid losses in federal funding.

Date CMS Approved Waiver	Effective Date of Final Rule	Eligible for Transition Period?	State Fiscal Year Begins	Compliance Deadline
July 1, 2016	January 1, 2026	Yes	April 1	April 1, 2027*
July 1, 2016	February 1, 2026	Yes	January 1	January 1, 2028**
December 10, 2024	January 1, 2026	No	N/A	January 1, 2026
December 10, 2024	February 1, 2026	No	N/A	February 1, 2026

* Under existing regulations, a modified waiver package would need to be submitted to CMS for approval by June 30, 2027 to have a retroactive April 1, 2027 effective date. CMS is also considering a number of different alternatives for the transition period, including on the one hand, narrowing the availability of the transition period to state taxes with waivers approved more than three years prior to the effective date, and on the other hand, extending the transition period to one year for states with more recent tax waiver approvals (i.e., within the last two or three years) and two years for states with older tax waiver approvals.

States with recent waiver approvals, such as New York, California, Michigan, and Massachusetts, may need to act quickly to re-evaluate their existing tax structures. This may include identifying Medicaid-heavy tax metrics, engaging affected providers, and assessing whether changes in state laws or regulations related to state taxes are needed. CMS's stated position that existing tax waivers do not meet the new requirements suggests that significant structural changes, not just technical adjustments, may be needed. States can no longer rely on prior approvals and may consider preparing now to modify their tax structures to meet the proposed requirements as of the effective date of any final rule.

Notably, this regulatory effort coincides with legislative activity in Congress on the same topic. On May 14, the House Energy and Commerce Committee advanced its portion of the fiscal year 2025 budget reconciliation bill, which includes multiple amendments to the Medicaid statute to limit states' use of health care-related taxes. The Bill would impose a federal moratorium on new or increased provider taxes, and proposes to codify in the Medicaid statute conditions for when a health care-related tax is not "generally distributive."[3] The conditions outlined in the bill are substantially similar to the conditions CMS included in the Proposed Rule. The bill also would authorize the Secretary to determine an appropriate transition period, not to exceed three fiscal years. If enacted by Congress later this summer, that may accelerate the time frames for compliance with the new requirements compared to the time required for CMS to consider submitted comments and finalize the Proposed Rule.

FOOTNOTES

[1] *Preserving Medicaid Funding for Vulnerable Populations – Closing a Health Care-Related Tax Loophole Proposed Rule*, **Ctrs. For Medicare & Medicaid Servs.** (May 12, 2025).

[2] *Id*.

[3] Comm. Print Providing for Reconciliation Pursuant to H. Con. Res. 14, Subtitle D—Health, § 44131, 44132,44134, 119th Cong. (2025).

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