The MCO Tax
Item 4260-101-0001

PRESENTED TO:

Budget Conference Committee
Hon. Holly J. Mitchell, Chair

LEGISLATIVE ANALYST'S OFFICE

Background

Federal Government Regulates Health Care-Related Taxes. The federal government has rules that regulate states' health care-related taxes to the extent that they are used to draw down federal Medicaid funds. Principally, to receive federal approval, a state must prove to the federal government that the burden of paying a health care-related tax does not fall too disproportionately on Medicaid as opposed to non-Medicaid services.

California Currently Has a Health Care-Related Tax on Managed Care Organizations (MCOs). Since 2016-17, the state has imposed a per-member, per-month tax on the Medi-Cal and commercial enrollment of MCOs. The existing MCO tax (there have been prior versions with different structures) features a tiered tax rate structure whereby the tax rate varies based on Medi-Cal versus commercial enrollment and by the number of enrollees an MCO has. The existing MCO tax expires at the end of 2018-19.

MCO Tax Package Reduced Other State Taxes on MCOs. The current MCO tax was enacted as a part of a larger tax reform package that cut other taxes paid by some MCOs and certain affiliated health insurance companies for the period the MCO tax is in effect. Specifically, during the period in which the MCO tax is in effect, MCO income normally subject to the corporation tax is exempted from taxation and the insurance tax rate is set to zero for the health insurance premium revenue of MCO-affiliated companies.

Existing MCO Tax Generates a $1.5 Billion Net General Fund Benefit. . . The $1.5 billion net General Fund benefit from the MCO tax package equals the difference between total MCO tax revenues and the combination of (1) the General Fund portion of the cost to pay MCOs back for the tax amounts that they pay on their Medi-Cal lines of business (the federal government pays the remaining portion of the Medi-Cal share) and (2) the loss of General Fund revenue associated with the reductions to the insurance and corporation taxes.

Background

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. . . And Is Estimated to Leave California's Health Industry Overall No Worse Off. The MCO tax package was designed to at least fully offset, on net, the state tax liability of the health insurance industry as a whole. In 2018-19, the most recent estimates show that the MCO tax package reduced the state tax liability of the health insurance industry overall by around $5 million, relative to what its liability would have been absent the MCO tax package. However, under the MCO tax package, certain plans were expected to see their net tax liability decline while others were expected to see their net tax liability increase.

Expiration of MCO Tax Will Eliminate the Associated General Fund Benefit. In 2019-20, the expiration of the MCO tax package (unless reauthorized) is projected to reduce General Fund resources by between $700 million and $800 million. We expect the full fiscal impact of the expiration of the MCO tax package—the loss of the full $1.5 billion net General Fund benefit—to materialize in 2020-21 or later. The fiscal impact is less in 2019-20 because of delays in when MCO tax revenue is available to offset General Fund costs in Medi-Cal.

Legislative Staff Requested That the LAO Model Options for a Reauthorized MCO Tax Package. Legislative staff requested the LAO to model options for a reauthorized MCO tax package, taking into account changes in the health insurance industry—the two most important being (1) consolidation in the industry due to certain MCOs acquiring other MCOs and (2) changes over time in MCO enrollment.

Objectives of a Reauthorized MCO Tax. We sought a number of objectives in developing options for a reauthorized MCO tax. Due to the complexities of federal regulations on health care-related taxes as well as other factors, many of these objectives can come at cross-purposes. As a result, an ideal structure for a reauthorized MCO tax must strike a balance between often competing objectives. The major objectives behind our MCO tax models included:

- ***Comply With Federal Rules on Health Care-Related Taxes.*** Because of the importance of drawing down federal Medicaid funds with the MCO tax, it was critical that our options comply with federal rules on health care-related taxes.
- ***Maintain or Increase the Net General Fund Benefit.*** Our objective was to generate a net General Fund benefit of at least $1.5 billion.
- ***Protect Vulnerable MCOs From Negative Impacts.*** We sought to prevent significant negative impacts on select, relatively small MCOs. For example, we exempt certain MCOs whose tax liability would otherwise represent a significant share of their overall revenues.
- ***Minimize Negative Impacts on the Industry Overall.*** Finally, we sought to minimize negative impacts on the health insurance industry. One way we did so was by generating a net fiscal benefit for the health insurance industry overall by making sure that the MCO tax applicable to MCOs' commercial lines of business is less than the tax benefits received by MCOs and their corporate affiliates through the reductions to the corporation and insurance taxes. Another way we sought to minimize negative health insurance industry impacts was to spread the commercial tax burden more evenly across MCOs.

Goals and Models for a Reauthorized MCO Tax Package

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Legislature Considered Multiple Options for the Reauthorization of the MCO Tax Package. We provided legislative staff with three illustrative options for a reauthorized MCO tax package: (1) maintain the existing MCO tax's tax tiers and tax rates, (2) maintain the existing tax tiers but marginally increase the tax rates, and (3) maintain the tax tiers but significantly modify the tax rates. All three options would maintain the reductions in the insurance and corporation taxes for MCOs and their corporate affiliates. Under our modeling, the third option generated the greatest net General Fund benefit for the state ($1.8 billion versus $1.5 billion or less) while at the same time limiting negative impacts on the health insurance industry.

Comparison of MCO Tax Packages

Governor Did Not Propose to Reauthorize the MCO Tax Package. The Governor did not propose to reauthorize the MCO tax package, thereby foregoing the $1.5 billion net General Fund benefit.

Senate Approved a Three-Year Reauthorization With Modified Tax Rates. The Senate adopted placeholder trailer bill language to reauthorize the MCO tax package for three years through 2021-22. The Senate's budget package includes General Fund savings in Medi-Cal consistent with the net General Fund benefit that would be available under the third MCO tax option that we described above.

Assembly Approved a Four-Year Reauthorization With Modified Tax Rates. The Assembly also approved the reauthorization of the MCO tax package and includes in its budget package a net General Fund benefit that is consistent with the net General Fund benefit that would be available under the same MCO tax option selected by the Senate. Unlike the Senate, the Assembly reauthorized the MCO tax package for four years through 2022-23.

Senate and Assembly Both Adopted the Same MCO Tax Option. Both the Senate and Assembly budget packages adopted the option that we modeled for a reauthorized MCO tax package that generates the greatest net General Fund benefit and reduces the negative impact on the health insurance industry. Both the Senate and Assembly MCO tax package reauthorizations would maintain the reductions in the corporation and insurance taxes for MCOs and their corporate affiliates. The figure on the next page compares the tax rates of the existing MCO tax and the option for a reauthorized MCO tax that was adopted by both houses.

Comparison of MCO Tax Packages

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Comparing the Tax Rates of the Existing Versus the Reauthorized MCO Tax Adopted by Both Houses

	Tax Rate Per Member Month	
Member Months[a]	**Existing Tax**	**Tax Reauthorization Adopted by Both Houses**
Medi-Cal Enrollees		
1 - 2,000,000	$45.00	$70.00
2,000,001 - 4,000,000	21.00	17.00
4,000,001 and above	1.00	1.00
Non-Medi-Cal Enrollees		
1 - 4,000,000	8.50	6.50
4,000,001 - 8,000,000	3.50	3.50
8,000,001 and above	1.00	1.00
AHCSP Non-Medi-Cal Enrollees[b]		
1 - 8,000,000	2.50	2.50

[a] A member month is defined as one member being enrolled for one month in an MCO.

[b] An AHCSP is defined as a nonprofit health plan that has high statewide enrollment, owns or operates pharmacies, and exclusively contracts with a single medical group in all of its geographic areas of operation.

MCO = managed care organization and AHCSP = alternate health care service plan.

Comparison of MCO Tax Packages

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The figure below compares the fiscal impacts of the existing MCO tax package and those of the option for a reauthorized MCO tax package adopted by both houses.

Fiscal Impact of the Existing and Adopted Reauthorization of the Managed Care Organization Tax

(In Millions)

	Existing tax	Tax Reauthorization Adopted by Both Houses
Net General Fund benefit	$1,563	$1,831
Net fiscal benefit for the health insurance industry	5	93

Summary of Differences Between the Houses. The most significant difference between the Senate and the Assembly's MCO tax packages is the additional year that the Assembly package would maintain the reauthorized MCO tax package. The only other difference between the two houses reflects technical differences in when the net General Fund benefit from the reauthorized tax package are assumed to materialize. Because MCO tax revenues flow through Medi-Cal, and Medi-Cal is on a cash as opposed to accrual budget, delays in when the revenues are available to Medi-Cal affect what year the savings will materialize. The Senate budget package assumes that about 75 percent of the net General Fund benefit will materialize in 2019-20, whereas the Assembly budget package assumes that about 50 percent of the net General Fund benefit will materialize in 2019-20. We would note that the portion of the net General Fund benefit that does not materialize in the first year of a reauthorized MCO tax package will be available in a later year. The figure on the next page summarizes the multiyear differences between the two houses.

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Net General Fund Benefit Due to the Reauthorization of the MCO Tax
(In Millions)

	2019-20	2020-21	2021-22	2022-23	2023-24	Average Annual Net General Fund Benefit[a]
Governor	—	—	—	—	—	—
Senate	$1,373	$1,831	$1,831	$458[b]	—	$1,831
Assembly	858	1,844	1,844	1,844[c]	$934[b]	1,831

[a] This reflects the average annual net General Fund benefit for the years the reauthorized MCO tax package would be in effect.
[b] Due to delays in when MCO tax revenues will be available to Medi-Cal, a portion of the net General Fund benefit from the MCO tax is projected to materialize after the expiration of the reauthorized tax.
[c] The Assembly package reauthorizes the MCO tax package through 2022-23, whereas the Senate reauthorizes the package through 2021-22.
MCO = Managed Care Organization.