DEPARTMENT OF HEALTH & HUMAN SERVICES
Centers for Medicare & Medicaid Services
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Financial Management Group

Dear State Medicaid Director:

We are writing to follow up on CMS's November 14, 2025, Dear Colleague Letter regarding Section 71115 of Public Law 119-21, which CMS refers to as the "Working Families Tax Cut (WFTC) legislation," and its new indirect hold harmless thresholds for provider taxes. As reflected in the proposed rule that appeared in the July 23, 2026, Federal Register (91 FR 46562), CMS intends to address the details of this provision through notice-and-comment rulemaking. The comment period for this rule closed September 21, 2026, and section 71115 applies for fiscal years beginning on or after October 1, 2026. This email is intended to provide initial information regarding the period after section 71115 begins to apply and before a final implementing rule is effective. The information that follows concerns CMS's handling of health care-related taxes during this period.

Background

Section 1903(w) of the Social Security Act (the Act) establishes requirements for health care-related taxes, including a prohibition on hold harmless arrangements under which taxpayers receive their tax costs back through Medicaid or other payments. Federal regulations specify that an indirect hold harmless arrangement is determined to exist where tax collections for a permissible class exceed a threshold percentage of net patient revenue (historically 6 percent), on the premise that collections above that level are likely being returned to taxpayers. Under current regulations, a tax exceeding the threshold may still be permissible if it passes a second prong, the "75/75 test"; the proposed rule would discontinue that second prong for Federal fiscal years beginning on or after October 1, 2026. If an indirect hold harmless arrangement exists, the tax revenues are deducted from the state's medical assistance expenditures before FFP is calculated.

Section 71115: New Indirect Hold Harmless Thresholds

Section 71115 amended section 1903(w)(4) of the Act (42 U.S.C. 1396b(w)(4)) to establish, for fiscal years beginning on or after October 1, 2026, new state- and permissible class-specific indirect hold harmless thresholds. Except as provided for expansion states, the applicable threshold for each state and permissible class will equal the applicable percent of net patient revenue for taxes enacted and imposed as of July 4, 2025. This generally precludes new or increased provider taxes that would cause tax collections for a permissible class to exceed the new threshold. For expansion states, section 71115 establishes a separate phase-down for certain permissible classes beginning in fiscal year 2028.

Immediate Next Steps: Applicability of Section 71115 and Rulemaking Timing

Because section 71115 applies for fiscal years beginning on or after October 1, 2026, but CMS's final rule is not yet in place, we want to give states information now about how CMS intends to handle this period. Below, we explain how CMS will continue to process tax waivers and

payment proposals, describe how CMS will provide technical assistance and work with states to correct data reporting issues, and clarify points of confusion raised by states about how section 71115 operates.

Processing of Tax Waivers and Payment Proposals

In the proposed rule, CMS proposed a process for states to report interim data on taxes that were enacted and imposed as of July 4, 2025, which CMS would use to calculate interim thresholds. The interim thresholds are intended to address the period between the first fiscal year to which the amended section 1903(w)(4) thresholds apply and the point at which final data becomes available to calculate final thresholds. Although non-binding, the interim thresholds would provide a reference point for monitoring and evaluating tax waiver submissions while awaiting final threshold calculations. CMS faces that gap now: the amended thresholds under section 71115 apply for fiscal years beginning on or after October 1, 2026, which CMS has proposed to interpret and intends to apply on a Federal fiscal year basis (i.e., beginning with FFY 2027); final data to calculate final thresholds are not yet available; and the data collection CMS proposed is not yet in place.

CMS will continue to review and process tax waivers and the financing review of payment proposals such as state-directed payments and state plan amendments, and States may continue submitting such items. CMS will evaluate these submissions against the statutory requirements by evaluating whether the tax reflects an increase that likely is not possible under the new requirements. Any approval will be accompanied by language making clear that the approval is not a determination of the state's applicable threshold. The state will need to adjust its tax collections as necessary to comply with the final threshold once determined, for periods on or after October 1, 2026, and in a manner that preserves the broad-based and uniform nature of the tax or any approved waiver. If collections for a permissible class exceed the applicable threshold, revenues from all taxes on that class are subject to deduction from the state's medical assistance expenditures before FFP is calculated.

States should be aware that certain proposal characteristics will prompt additional scrutiny and may require further information before CMS can complete its review. For example, CMS may ask additional questions when a proposal includes proposed tax rate increases. Likewise, if a proposal substantially restructures a state's tax methodology to a design not previously used, CMS will need to understand the basis for the change before adjudicating the proposal.

Technical Assistance and Correction of Data Reporting Issues

As states examine their existing taxes in preparation for the new thresholds, CMS has received a growing number of questions and requests for technical assistance regarding the correct application of statutory and regulatory requirements to health care-related taxes. We also identified several recurring data issues in the CMS-64 tax data that states submitted at CMS's request in Fall 2025. States may understandably be concerned about how these issues could affect their preparations for the new thresholds. As explained in the discussion that follows, CMS has already built a solution for this into the proposed rule.

Under the proposed rule, thresholds would ultimately be calculated from one-time final data submissions that states have not yet made. CMS addressed one of the recurring data issues

directly in the proposed rule, explaining that CMS "intends to work with States to ensure proper attribution of revenue amounts obtained from combined data sources, such as inpatient and outpatient hospital revenue," which must be disaggregated into their individual permissible classes. 91 FR 46562, 46573. The proposed rule further explains that, in general, CMS does not intend to take enforcement action based on misattributions, depending on the circumstances, and that where misattributions have occurred, CMS will work collaboratively with states to correct them, while making clear that "under no circumstance can revenues from a different class of items or services be included in the calculation." *Id.* For ongoing compliance reporting once thresholds are set, the proposed rule would also allow states to amend reported data for up to two years and would provide a remediation period in which to correct reporting and, where necessary, adjust tax collections before CMS assesses compliance for a given fiscal year. These proposals are not final and may change in a final rule. In the meantime, CMS will continue to provide technical assistance on the application of the statutory and regulatory requirements and to work with states to identify and correct data reporting issues of this kind so they can be resolved before they affect a state's final indirect hold harmless threshold or claimed expenditures.

Clarifying Operation of Section 71115

CMS also wants to address a misunderstanding about how section 71115 operates, which we have heard from several states. Some states have read the statute's reference to taxes a state "has enacted" and "imposes" as of July 4, 2025, to mean that their specific tax structures as they existed on that date, are "grandfathered" going forward (either that they cannot be changed, or that they will not be reviewed further). Neither is the case.

Section 71115 amended section 1903(w)(4) of the Act to replace the 6 percent indirect hold harmless threshold with an applicable percent for each permissible class, which CMS determines based on taxes a state had enacted and imposed as of July 4, 2025. It does not otherwise prescribe a state's specific tax structure. Within a permissible class, states may modify, replace, or end taxes, provided that aggregate collections for that class remain within the applicable threshold and the tax otherwise satisfies all applicable Federal health care-related tax requirements, including any applicable waiver requirements. Likewise, longstanding Federal legal requirements and CMS policies regarding how the indirect hold harmless threshold is calculated remain unchanged by the legislation. These include that the threshold is applied on a permissible class basis and that the denominator is the net patient revenue of all providers in the class statewide.

Similarly, compliance with the applicable indirect hold harmless threshold does not, by itself, establish that a health care-related tax is permissible. A health care-related tax must satisfy all applicable requirements under section 1903(w) of the Act and 42 CFR part 433, including the permissible class requirement, the broad-based and uniformity requirements (or an approved waiver), and the hold harmless requirements. CMS may therefore review a tax for compliance with applicable requirements even if tax collections do not exceed the applicable indirect hold harmless threshold.

We hope this email serves to provide clarity during this period. If you have questions about this guidance or need technical assistance, please contact taxwaiver@cms.hhs.gov.