

MCO Tax Lawsuit and Proposition 35 Frequently Asked Questions



California's MCO Tax

Q: What is the Managed Care Organization (MCO) tax, and why is it important to Medi-Cal?

A: The MCO tax is a funding mechanism that helps California finance Medi-Cal. The state taxes managed care organizations allowing California to draw down additional federal matching funds. It has been an important source of Medi-Cal financing for many years.

Q: What is Proposition 35, and what did it change?

A: Approved by nearly 68% of California voters in November 2024, Proposition 35 made the MCO tax permanent under state law, subject to continued federal approval. It established limits on the tax imposed on commercial health plan enrollment, dedicated revenue to specified Medi-Cal purposes and established requirements for amending the voter-approved law.

Proposition 35 also changed how the state can use MCO tax revenue. Historically, the tax helped cover Medi-Cal costs that otherwise would have required General Fund dollars. Proposition 35 established dedicated funding requirements intended to direct more of that revenue toward specified health care services and investments.

Q: What changed recently with the MCO tax?

A: New federal requirements under H.R. 1 mean California must adjust its existing MCO tax structure. In response, the state adopted a new MCO tax structure through its 2026–27 budget and SB 125, which substantially increases the tax tied to commercial health coverage. The new structure also uses MCO tax revenue to cover costs that otherwise would have been paid with General Fund dollars, freeing those dollars for other spending priorities rather than directing them toward additional Medi-Cal investments.

Under SB 125, the commercial-enrollment tax is \$8.85 per enrollee per month, compared with the \$2.50 limit established by Proposition 35. CMA and CAHP contend that the new structure and use of tax revenue violate the voter-approved law.

Q: How could the state's MCO tax affect Californians with commercial health coverage?

A: Health plans are responsible for paying the MCO tax, but higher taxes on health plan enrollment increase the cost of providing commercial health coverage and can ultimately put additional pressure on premiums paid by California's working individuals, families and employers.

According to the Legislative Analyst's Office, approximately \$1.5 billion, or two-thirds of the renewed tax's net funding, would come from commercial enrollment.

When Medi-Cal is underfunded, all California patients feel the consequences. Prop. 35 requires MCO tax revenue to be used to expand access to Medi-Cal care. Instead, the state is using those dollars to backfill the General Fund—diverting resources away from patients who need access to care.

Diverting resources away from Medi-Cal leaves patients without timely access to care, even for those with commercial plans. Patients who cannot get care end up in already-crowded emergency rooms, increasing wait times for everyone. And when hospitals and clinics struggle financially, communities can lose critical providers altogether.

Protecting Medi-Cal funding isn't only about protecting coverage for Medi-Cal patients. It's about protecting access to care for all Californians.

Understanding the Lawsuit

Q: Why are CMA and CAHP suing the state?

A: CMA and CAHP support the MCO tax as an important source of Medi-Cal funding. The lawsuit challenges the state's tax structure, which circumvents voter-approved Proposition 35 in three main ways: it exceeds the voter-approved limit on taxes tied to commercial health coverage, does not follow Proposition 35's requirements governing how tax revenue is used and was enacted without the three-fourths legislative vote required for amendments to Proposition 35.

California can respond to the new federal requirements without disregarding the protections voters established.

Q: Does the lawsuit seek to eliminate the MCO tax or take funding away from Medi-Cal?

A: No. CMA and CAHP support preserving the MCO tax as a sustainable source of Medi-Cal funding. The lawsuit challenges how the state has structured its tax, not the existence of the tax itself.

Our goal is an MCO tax that complies with both Proposition 35 and federal law, preserves dedicated funding for health care and avoids unnecessarily increasing costs for Californians with commercial health coverage.

Q: What are CMA and CAHP asking the court to do?

A: We are asking the court to declare SB 125 invalid to the extent it conflicts with Proposition 35, require the state to pursue an MCO tax structure that complies with both state and federal law before the federal transition period for compliance with H.R. 1 ends on December 31, 2026, and ensure MCO tax revenues are handled consistently with Proposition 35's dedicated funding requirements to increase access to Medi-Cal care.

Q: Why can't California simply keep its existing MCO tax?

A: H.R. 1 changed federal requirements governing Medicaid provider taxes, including restrictions on tax structures that impose disproportionately higher rates on Medicaid enrollment than on other coverage.

California's existing MCO tax remains federally authorized through December 31, 2026. The state therefore needs to develop a structure that can satisfy the new federal requirements. CMA and CAHP contend that California can do so while also complying with Proposition 35.