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Editors: Leslie Demaree Goldsmith and Carel T. Hedlund

A Second Court of Appeals Rules Against Hospitals in Medicare "Provider Tax" Case

By: Thomas W. Coons

Most states assess taxes against hospitals or other providers as a means of funding their Medicaid programs. The revenues generated by the taxes are used, with CMS's approval, to fund Medicaid payments to various providers, and the federal government participates in these Medicaid payments by paying its share (called Federal Financial Participation). Many Medicare providers have then claimed those taxes on their Medicare cost reports, and, until recently, Medicare had been paying its share of those taxes. This practice was consistent with the general principle that taxes assessed against providers are allowable costs under Medicare, but the practice has faced harsh scrutiny by the courts.

We previously reported on the *Kindred* decision, in which the U.S. Court of Appeals for the Eighth Circuit ruled that hospitals must offset amounts received from a voluntary hospital pool against the amount of the provider tax claimed for Medicare reimbursement. Now a second court of appeals decision again casts a shadow on this practice, by upholding another offset.

On October 16, 2012, the U.S. Court of Appeals for the Seventh Circuit upheld the decision of the CMS Administrator that, in determining the amount of allowable tax costs for Medicare purposes, Medicaid revenues received directly from the state must be offset against the tax assessments. *Abraham Lincoln Mem. Hosp., et al. v. Sebelius*, No. 112807 (7th Circ.) [PDF]. The court followed the well-established principles that the Secretary's interpretation of her own regulations is entitled to substantial deference and that the Secretary has wide latitude in developing methods of determining costs. The court then ruled that the offset was consistent with the general statutory definition of reasonable costs as meaning the "costs

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actually incurred" and with regulations that required that refunds, rebates, credits or "other discounts" be accounted for by "offsetting the costs to which they relate." In this case, the court ruled, the Illinois legislation had made it plain that the state's payments to the taxed hospitals served to reduce the related expense (the tax assessment). The plain language of the legislation, according to the court, "show[ed] a clear relationship between the access payments and the tax assessments" and to ignore this fact would have violated the statutory directive that healthcare providers be reimbursed only for their costs actually incurred, "i.e., their net costs." The court ruled that the Administrator had properly looked at the economic impact of the hospitals' receipt of payments from the state to determine the hospitals' next net tax assessment cost and that it was proper for her to conclude that the tax "costs" were offset by these payments.

The court further concluded that although HHS had previously ruled that the tax was a permissible Medicaid tax arrangement, this in no way changed the analysis. According to the court, the hospitals' arguments to the contrary, failed to address the key differences between Medicare and Medicaid, which are different programs with different statutory authority. Although the assessments might have been an appropriate Medicaid tax, there is no statutory language in the Medicare Act mandating that an interpretation of the Medicaid Act controls how one is to interpret the Medicare Act.

Moreover, the court said, the Secretary's decision was not an arbitrary and capricious reversal of long standing policy. The court said that a handful of prior Board decisions that purportedly showed HHS's long standing policy were not authoritative. Moreover, those decisions relied upon by the hospitals did not directly address the issue of offsets. Finally, even were the Administrator's decision inconsistent with prior policy, the court said, the Administrator was not required to explain a departure from previous interpretations. According to the court, it is well established that an agency may announce new principals in an adjudicative

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proceeding. In any event, the court ruled, decisions in which an administrative tribunal finds "distinctions is not reversing course; it is not like first deciding that cars must be equipped with airbags and then that they need not be; it calls for no special explanation."

Ober|Kaler's Comments

The CMS Administrator's decision in this case, issued in March 2010, was followed by a "clarification of policy" published in CMS's FY 2011 IPPS final rule. That clarification stated that, while provider taxes are generally allowable, Medicare contractors should review claims for such taxes to determine whether an offset of Medicaid revenue should be made. The clarification, however, provided little guidance to Medicare contractors as to how they should make this determination.

The CMS clarification of policy combined with this decision means that Medicare contractors will likely disallow costs for provider taxes on a more frequently basis, and continue to offset Medicaid revenues against the tax assessment. This will affect hospitals paid on a reasonable cost basis, such as critical access hospitals, as well as other hospitals that have elements of reimbursement that rely on reasonable costs. Thus, providers and their associations should work with the Medicaid agencies, if possible, to fashion provider tax programs in such a way that Medicare is less able to assert that the providers did not "actually incur" the tax expense.

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