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February 19, 2013

To: The Honorable David Y. Ige, Chair,
The Honorable Michelle N. Kidani, Vice Chair, and
Members of the Senate Committee on Ways and Means

Date: Friday, February 22, 2013
Time: 9:00 a.m.
Place: Conference Room 211, State Capitol

From: Dwight Y. Takamine, Director
Department of Labor and Industrial Relations

Re: S.B. No. 510 S. D. 1 Relating to Professional Employer Organizations

I. OVERVIEW OF PROPOSED LEGISLATION

The intent of S.B. 510 S. D. 1 is to rectify the conflict between existing statutory requirements relating to professional employer organizations (PEO) by: 1) repealing Chapter 373K, HRS; and 2) amending Chapter 373L, HRS, and Section 237-24.75, HRS, to clarify PEO responsibilities for purposes of qualifying for the state general excise tax exemption and requires PEOs to obtain a bond on a sliding scale that is based on total payroll amount. This measure seeks to balance PEO business interests with state regulatory oversight by establishing a resolute and balanced registration process to qualify for tax incentives while protecting employees' rights and benefits.

The Department strongly supports this measure, which retains the essential elements and objectives of current PEO laws but facilitates compliance by identifying and overcoming those barriers that have frustrated efforts to fully implement those laws. This proposal includes the recommendations of the various stakeholders, following internal deliberations and discussions since the veto of SB2424 in 2012.

II. CURRENT LAW

Chapter 373K was enacted in 2007 to allow PEOs to become eligible for the tax exclusion under section 237-24.75, whereas Chapter 373L was adopted in 2010 to regulate the PEO business by enforcing registration and bonding requirements. Effective implementation of both laws has been hampered by incompatible language, ill-defined goals and a lack of a common appreciation of the benefits intended or results to be realized.

III. COMMENTS ON THE SENATE BILL

S.B. No. 510 SD1 is a collaborative effort, including between the Department of Taxation and the Department of Labor and Industrial Relations to enhance implementation by clarifying inconsistencies between two separate but interrelated chapters in the HRS and limiting regulatory controls to only those critical to maintaining the integrity of the PEO industry and the statutorily mandated benefits and protections of Hawaii's labor laws.

DLIR believes that the stakeholders with interest in current PEO legislation are mostly in agreement with the needed changes to reconcile the two PEO chapters. All parties are in accord with the concept that the monitoring functions required by Chapter 373L would be best enforced by tying compliance to the general excise tax exemption, that the registration requirements for PEOs should be less burdensome, that essential information should be included in the notification to DLIR, and implementing a sliding bonding scale tied to the PEO's total payroll.

L E G I S L A T I V E

TAXBILLSERVICE

126 Queen Street, Suite 304 TAX FOUNDATION OF HAWAII Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: GENERAL EXCISE, Professional employer organizations

BILL NUMBER: SB 510, SD-1

INTRODUCED BY: Senate Committee on Commerce & Consumer Protection

BRIEF SUMMARY: Amends HRS section 237-24.75 to replace the term “professional employment organization” with “professional employer organization.” Clarifies that the general excise tax exemption shall not apply to a professional employer organization if: (1) the professional employer organization fails to properly register with the department of labor and industrial relations (DLIR); or (2) the professional employer organization fails to pay any tax withholding for covered employees or any federal or state taxes for which the professional employment organization is responsible.

Makes other nontax amendments to simplify the regulation of the professional employer organization law and clarify the application of existing laws.

EFFECTIVE DATE: Upon approval

STAFF COMMENTS: In 2007 the legislature, by Act 225, established HRS chapter 373K to provide that amounts received by a professional employment organization from a client company in the course of providing professional employment services that are disbursed as employee wages, salaries, payroll taxes, insurance premiums, and benefits are exempt from the general excise tax. Act 129, SLH 2010, established registration requirements for the professional employment organizations and established a new HRS chapter 373L. However, this measure repeals HRS chapter 373L and strengthens the provisions of HRS 373K and also clarifies the general excise tax exemption for professional employment organizations.

Digested 2/21/13

Proservice HAWAII
HR ADMINISTRATION

Comments to the Committee on Ways And Means
Friday, February 22, 2013
9:00 a.m.
Conference Room 211

<u>RE: SENATE BILL 510 SD1 RELATING TO PROFESSIONAL EMPLOYER ORGANIZATIONS</u>

Chair Ige, Vice Chair Kidani, and Members of the Committee:

We appreciate your efforts to assure there are reasonable regulations in place to protect our small business and working families who rely on Professional Employer Organizations (PEO) for payroll and mandated insurance and employment benefits. Thank you for the opportunity to submit comments.

SUMMARY OF CONCERNS

- Co-employment language – Based on testimony previously submitted on SB 510, the Hawaii's PEO industry has fundamental concerns about imposing liabilities on the PEOs on activities PEOs are unable to control on the Client Companies worksite. This concern stems from the current language in SB 510, which defines PEOs as "leasing companies", who hires employees and then assigned them to the client's worksite. This is an inaccurate and antiquated depiction of the PEO's current business model. Today's PEOs operate on a co-employment model in which employer responsibilities are shared between the PEO and client company. HAPEO (representing many small PEOs in Hawaii), ProService, and Altres share this concern. .

- Bond amounts – the $25,000 and $75,000 sliding scale bond amounts are insufficient to trigger a thorough review by an independent third party. An independent review is paramount ensuring the PEO is responsibly handling client company funds. The lower bond amounts provides little consumer protection, therefore we respectfully suggest the minimum bond amount should be $100,000.

- Audit requirement – If the Legislature prefers not to increase the bond amounts in SB 510 SD1, we ask that the financial audit requirements in HRS 373L be incorporated into the bill. A financial audit requirement will ensure that all PEOs have been reviewed thoroughly by independent third party, a goal that this measure's minimal bond requirement will fail to achieve. As explained below, a financial audit requirement is a power tool for regulators to protect our consumers.

SB 510 SD1 is a compromise to address the concerns of smaller PEOs. We appreciate the efforts to incorporate the ideas and opinions of PEOs of all sizes, but in the attempt to placate smaller PEOs, the bill made adjustments to the registration law (i.e., lowering the bond amount) to the detriment of our small business, working families, and the PEO industry.

I. BACKGROUND

ProService Hawaii provides employee administration services to over 1,000 small businesses in Hawaii, representing over 13,000 employees in Hawaii. As a professional employer organization (PEO), we ensure that our clients remain compliant with Federal and State employment and labor laws, while allowing them to focus on their core business, providing needed and valuable services to the people and the economy of the State. In addition, we ensure that our clients' employees receive timely payment of wages, workers' compensation, TDI and benefits coverage. We also provide HR training and services, dispute resolution, and safety services to our clients and our clients' employees.

Despite some PEOs' claims that there is no need for regulation of the industry, or minimal regulation at best, when PEOs are handling large sums of client funds, the opportunities for misuse or error are present, and such behavior (while fortunately rare), has happened both on the mainland and in Hawaii – in Hawaii as recently as 2007 with a start up PEO. In fact, a simple Google search of the phrase, "fraud PEO" returns a number of instances where PEOs have abused their fundamental responsibilities. Some areas of common abuse are; collecting insurance premiums but not remitting them to the insurance carrier, not paying employees on time, closing business without remitting final paychecks to employees. Because our clients deserve the peace of mind that they have contracted with a reputable PEO, ProService has been voluntarily regulated by the Employer Services Assurance Corporation (ESAC), the gold standard for national independent oversight, auditing, and bonding, since 2006.

We support the efforts of this legislative body to regulate the PEO industry, as it is in this state's and our industry's best interests to have well-functioning firms serving the community. We support the intent of ensuring that only compliant and well-managed PEOs operate in Hawaii.

Under the nationally established PEO Model, there is a co-employment relationship of shared responsibilities between the client company and PEO. The client company, or "worksite" employer, maintains the control of day to day management. The client generally hires and terminates its employees, and not the PEO. The PEO serves as the client's administrative employer - providing payroll services, administering employment benefits – Workers' Compensation Insurance, Health Care Insurance, Unemployment Insurance, and Temporary Disability Insurance. <u>We believe our PEO registration laws should recognize that PEOs operate under a co-employer model with</u>

<u>shared responsibilities. Holding the PEO solely liable for any and all conduct by the client company and/or worksite employee is not good public policy and inconsistent in the way other jurisdictions and federal agencies regulate PEOs</u>. For example, both OSHA and EEOC, along with many state jurisdictions, hold the client or "worksite employer" responsible for conduct at the workplace and limit the PEOs responsibility to the scope of their services provided to the client company under the PEO services agreement.

There is an important distinction between a PEO model and a leasing model. Under an Employee Leasing model, the HR Agent hires and then leases the employees to Client Company. Under a PEO Model, all hiring, termination, and day to day control of the employees are generally in the sole responsibility and discretion of the Client Company.

It is our understanding that most, if not all of Hawaii PEOs operate under a PEO/co-employment Model. Therefore, ProService generally opposes any legislation that does not take this critical factor into account.

II . SENATE BILL 510

We offer the following comments on Senate Bill 510:

A. **Current Law – HRS 373L.** We recommend that the legislature allows the current law, HRS 373L to be fully implemented and enforced before taking any action on any proposed amendments to the current law. <u>We should look to maintain consumer protections by enforcing the existing law rather than repealing and implementing a new law that has fewer consumer protections</u>.

   1. **The Bonding Requirement in the Current Legislation is Reasonable.**

      a. The bond requirement in HRS 373L is reasonable and is not anti-competitive to smaller PEOs. For example, ProService secured a bond at the required amount of $250,000 for less than $2,000. This cost is nominal for the surety that it provides the Client Companies of the PEO and the State of Hawaii. The bond fee is not a barrier to entry into the marketplace.

      b. We have learned that only two Hawaii based PEOs – Altres and the ProService entities - are in compliance with the bonding requirement of the current law.

      c. HRS 373L-3(3) explicitly provides, "*Failure to have in effect a current bond shall result in automatic forfeiture of registration* *pursuant to this chapter shall require the professional employer organization to immediately cease doing business in the State*."

d. <u>We have learned that many PEOs continue to operate in our state in violation of the HRS 373-3(3)</u>. We are not privy to our state government's efforts in enforcing our current PEO registration laws.

2. The Financial Audit Provision Provides Needed Consumer Protection.

a. PEOs handle significant amounts of client funds. A financial audit provides regulators a fundamental tool in protecting our small business and their employees who have relied on PEOs. A financial audit can raise red flags on PEOs that are underfunded or improperly using clients' funds. The financial audit requirements in our current law is not cost prohibitive if the PEO is adhering to general accepting accounting principles, properly funded, and handling clients funds in accordance with best practices. Financial audits are part of PEO registration regulations in most states. It should be viewed as best practice in an industry that handles significant amount of client funds, rather than a hindrance to doing business in Hawaii. Proof of financial stability is imperative given the critical responsibilities that PEOs maintain.

b. According to court documents, in 2007 a start-up Hawaii PEO, Mainstay defrauded its clients by collecting $1,068,579 from its clients in payroll taxes and workers compensation premiums, and not using the funds for their intended purposes. Fortunately for its clients, Mainstay partnered with a Texas company who was financially able to cover those expenses. The Texas company subsequently sued Mainstay for fraud and theft.

c. As the Table A below indicates, even a "small" PEO handles a significant amount client funds. For example, a PEO that has 250 worksite clients will handle approximately $12 million dollars in client funds on annual basis.

Table A

Summary of PEO Pass-Through Funds

By Number of Employees

PEO Pass-Through Funds	**250 EEs**	**500 EEs**	**1000 EEs**	**2500 EEs**
Covered Employee Annual Payroll	11,150,000	22,300,000	44,600,000	111,500,000
Covered Employee Health Care Premiums	586,307	1,172,613	2,345,226	5,863,065
Client/Worksite Employee State Unemployment Taxes Due	265,085	530,169	1,060,338	2,650,846
Client Company Work Comp Premiums Due	189,550	379,100	758,200	1,895,500
Client Company TDI Premiums Due	44,470	88,939	177,879	444,697
Total Pass-Through Client Funds	**12,235,411**	**24,470,822**	**48,941,643**	**122,354,108**

B. SB 510 – Three Significant Areas of Concern:

1. Removal of Co-employment Language. As discussed above, PEOs do not "assign employees" to client worksites, but rather enter into co-employment agreements with client companies in which employment responsibilities are shared between parties. The current language inaccurately classifies PEO as "Leasing Companies" by removing the provisions and definitions relating to "co-employment".

   Accordingly, we request the following:

   - The definition of "client company" in Section 373L-1 to remain as follows:

     "Client Company" means any person who enters into a professional employer agreement with a professional employer organization."

   - The definitions of "co-employment" and "covered employee" not be deleted as the worksite employer maintains responsibility for statutory compliance and oversight at the worksite. This definition also supports the fact that it is the Client Company's responsibility to hire employees and that said employees are not "assigned" to the worksite by the PEO.

- The current definition of "Professional Employer Organization" to remain in place rather than deleting the existing definition and replace it with language about employee assignment. Emphasizing employee assignment or leasing could create confusion by inaccurately depicting the PEO model that most Hawaii PEOs operate under.

- The current language in Sec. 373L-B will allow client companies to contract out their liabilities and responsibilities as an employer. Allowing client companies to completely transfer their liability to a PEO will deteriorate self-enforcement that will negatively affect the worksite employees and their families. For example, it will exacerbate the cash-paying economy, which will negatively impact state taxation revenues, unemployment contributions, and the health of the workers' compensation, temporary disability and health care systems.

- Section 373L-B should be amended to state: "During the term of the agreement between a professional employer organization and its client company, the professional employer organization shall be deemed the employer for all assigned employers as defined in section 373L-1, <u>providing the client company has met its obligations and responsibilities under the agreement</u>."

  ProService is agreeable to the PEO being the employer of record for Unemployment Insurance, Workers' Compensation, Temporary Disability Insurance, and Health Care to the extent the client company performs its obligations and responsibilities under the PEO agreement.

2. <u>SB 510 removes the financial audit requirement</u>

   a. An independent financial audit by a CPA is necessary to verify financial stability and the ability to meet financial obligations. We respectfully ask that the financial audit requirement (373L-2(b)(12) be maintained. The financial audit requirement is reasonable and necessary to provide our regulators a tool to ensure a PEO is financially sound to meet its obligations. Financial audits are part of PEO registration regulations in most other states and are a best practice rather than a hindrance to doing business in Hawaii.

   b. Even small PEOs handle large amounts of client funds. Please see Table A, above. Oversight through a financial audit is proof that a PEO is maintaining financial integrity in the handling of client funds.

c. The cost of an audit is reasonable and in the best interest of protecting consumers.

3. <u>We support a sliding scale bonding requirement</u>.

a. A 3-tier sliding scale in which the amount of the bond will be based on the number of employees listed on the PEO's Unemployment Insurance Quarterly Filings (UC-B6).

b. The amount of the bond will range from $100,000 to $500,000. We believe the amount of the bond should be significant enough to require an independent review of the PEO's practices by a third-party. If the bond requirement is nominal (e.g., $25,000) a medium-size PEO will likely choose to self-fund the bond without going through a third-party's underwriting or review process. Doing so will bypass the protection afforded to consumers through the bond requirement. Accordingly, if the bond requirement is insignificant, we would like you to consider <u>not repealing</u> the financial audit requirement in our current law.

The table below outlines our proposed sliding-scale bonding requirement and the estimated costs for the bond based on Alpha Surety & Brokerage's testimony for 2012's SB 2424.

Number of Employees	Bond Amount	Cost of Bond (1-2% of bond amount)	Pass-through annual payroll
1,000 EEs	$100,000	**$1,000-$2,000**	$44,600,000
5,000 EEs	$250,000	**$2,500-$5,000**	$223,000,000
7,500 EEs	$500,000	**$5,000-10,000**	$334,500,000

We believe our proposal is fair and reasonable in light of: (i) the estimated amount the PEO will likely pay for such bond and (ii) the protection the bonding process will provide our consumers.

III. Conclusion

We respectfully ask that: (1) the current law be enforced; (2) the bonding and financial audit requirements are maintained; and (3) any amendments to the current law take into account the "co-employment" relationship between a PEO and client company. Thank you for the opportunity to submit comments.

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To: The Honorable David Y. Ige, Chair
and Members of the Senate Committee on Ways and Means

Date: Friday, February 22, 2013
Time: 9:00 a.m.
Place: Conference Room 211, State Capitol

From: Frederick D. Pablo, Director
Department of Taxation

Re: S.B. No. 0510, S.D.1 Relating to Professional Employer Organizations

The Department of Taxation (Department) supports the tax-related amendments proposed in S.B. 510, S.D.1. The Department provides the following information and comments for your consideration, and defers to the Department of Labor and Industrial Relations as to the merits of this measure.

As it relates to tax, this measure amends the general excise tax exemption for professional employer organizations that is set forth under section 237-24.75, Hawaii Revised Statutes (HRS) to provide that the exemption is not applicable upon the occurrence of certain specified events. The measure is effective upon approval.

With respect to the general excise tax exemption, the Department supports the suggested changes, as they will clarify the timing and circumstances under which the exemption will be denied to a professional employer organization.

The Department estimates that the bill will have no material effect on tax revenues.

Thank you for the opportunity to provide comments.