

SB 813

Measure Title: RELATING TO PROFESSIONAL EMPLOYER ORGANIZATIONS.

Report Title: Professional Employer Organizations; Registration and Fees; Enterprise Zone Coverage; General Excise Tax Exemption; Transfer of Experience Record as Successor Employer

Description: Amends definitions and adds registration and fee requirements for professional employer organizations; repeals chapter 373L, Hawaii Revised Statutes; amends the definition of leased employees for enterprise zone coverage of a qualified business; amends the general excise tax exemption for professional employer organizations; allows professional employer organizations to apply for a transfer of a client company's experience record for unemployment insurance contribution purposes.

Companion: [HB144](#)

Package: None

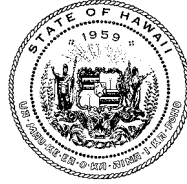
Current Referral: CPN, WAM

Introducer(s): CHUN OAKLAND, ESPERO, IHARA, Dela Cruz

<u>Sort by Date</u>		Status Text
1/18/2013	S	Introduced.
1/22/2013	S	Passed First Reading.
1/22/2013	S	Referred to CPN, WAM.
1/29/2013	S	The committee(s) on CPN has scheduled a public hearing on 02-08-13 9:00AM in conference room 229.

NEIL ABERCROMBIE
GOVERNOR

SHAN TSUTSUI
LT. GOVERNOR



STATE OF HAWAII
DEPARTMENT OF TAXATION
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FREDERICK D. PABLO
DIRECTOR OF TAXATION

JOSHUA WISCH
DEPUTY DIRECTOR

To: The Honorable Rosalyn H. Baker, Chair
and Members of the Senate Committee on Commerce and Consumer Protection

Date: Friday, February 8, 2013

Time: 9:00 a.m.

Place: Conference Room 229, State Capitol

From: Frederick D. Pablo, Director
Department of Taxation

Re: S.B. No. 813 Relating to Professional Employer Organizations

The Department of Taxation (Department) defers to the Department of Labor and Industrial Relations (DLIR) and the Department of Business and Economic Development on the merits of this measure. The Department, however, prefers S.B. 510, which is clearer with respect to the tax provisions.

As it relates to tax, S.B. 813 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, however, the Department notes that it has no means of knowing whether or not a Professional Employer Organization (PEO) is excluding an otherwise coverable persons, whether or not the PEO has failed to properly register with DLIR or to pay any required fees, or whether or not the PEO is otherwise in compliance with Chapter 373K, HRS. These determinations are solely within the province of the DLIR. The Department believes that the exemption should be suspended only upon notification from DLIR that the PEO has failed to comply with its rules and regulations.

In addition, the Department notes that although proposed subsection (3)(D) provides for the suspension to be upon notification from DLIR, that provision applies only to subsection (3)(D) and not to (3)(A) or (3)(B). The Department believes that the loss of the exemption should be clearly set forth so as to avoid time consuming litigation with taxpayers.

The Department suggests that subsection 3 of section 237-24.75 read as follows:

[-(3) Amounts received[-] by a professional [~~employment~~] employer organization from a client equal to amounts that are disbursed by the professional [~~employment~~] employer organization for employee wages, salaries, payroll taxes, insurance premiums, and benefits, including retirement, vacation, sick leave, health benefits, and similar employment benefits with respect to [~~assigned~~] covered employees at a client company; provided that this exemption shall not apply to a professional [~~employment~~] employer organization [~~upon failure of the professional employment organization to collect, account for, and pay over any income tax withholding for assigned employees or any federal or state taxes for which the professional employment organization is responsible.]~~ after:

- (A) Notification from the department of labor and industrial relations that the professional employer organization has, by or through any contract between a client company and any professional employer organization, or otherwise, excluded employees from any employee rights or employee benefits required by law to be provided to covered employees of the client company by the professional employer organization;
- (B) A determination by the department that the professional employer organization has failed to pay any tax withholding for covered employees or any federal or state taxes for which the professional employer organization is responsible;
- (C) Notification from the department of labor and industrial relations that the professional employer organization has failed to properly register with the director of labor and industrial relations or to pay fees as required by chapter 373K; or
- (D) Notification from the department of labor and industrial relations that the professional employer organization is not in compliance with chapter 373K.

Thank you for the opportunity to provide comments.

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 813

INTRODUCED BY: Chun Oakland, Espero, Ihara and 1 Democrat

BRIEF SUMMARY: Amends HRS section 237-24.75 to replace the term “professional employment organization” with “professional employer organization” and the term “assigned employees” with “covered employees.” Clarifies that the general excise tax exemption shall not apply to a professional employer organization if: (1) employees are excluded from any rights or benefits required by law to be provided to employees of the client company; (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; (3) the professional employer organization fails to properly register with the department of labor and industrial relations (DLIR) or pay required fees; or (4) the professional employer organization is not in compliance with HRS chapter 373K.

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 provisions of HRS 373K and also clarifies new standards in order to qualify for the general excise tax exemption for professional employment organizations.

Digested 2/6/13

EMPLOYER SERVICES
ASSURANCE CORPORATION

ESAC

The Foundation for
Integrity · Trust · Growth

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EMPLOYER SERVICES TRUST

Regions Bank, Trustee

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Sent February 7, 2013 via Email to CPNtestimony@Capitol.hawaii.gov
and via US Mail to:

The Honorable Rosalyn H. Baker, Chair
The Honorable Brickwood Galuteria, Vice Chair
Senate Committee on Commerce and Consumer Protection
State Capitol
415 Beretania Street
Honolulu, HI 96813

Re: Testimony of Employer Services Assurance Corporation concerning the Committee on
Commerce and Consumer Protection's February 8, 2013 hearing on S.B.510 & S.B.813 relating
to Professional Employer Organizations.

Dear Chair Baker and Vice Chair Galuteria,

On behalf of the Employer Services Assurance Corporation ("E·S·A·C"), the only national
accrediting and financial assurance organization for Professional Employer Organizations
("PEOs"), I applaud your past efforts to join the majority of states in regulating the PEO
industry by establishing Chapter 373L, Hawaii Revised Statutes ("HI's PEO law").

Effective regulation of PEOs will benefit both small businesses and workers in PEO
arrangements, as well as PEOs that operate in a responsible manner. It is important that such
regulation be done effectively, but not in an unnecessarily burdensome manner.

We understand your desire to balance important consumer protection goals with the goal of
allowing good PEO operators to continue to provide important benefits and services to Hawaii
business owners and employees. However, ESAC strongly urges you to require all PEOs to
meet meaningful financial requirements.

Just as with banks, insurance companies and other industries that aggregate client cash flow and
assume fiduciary responsibility, PEOs must be effectively regulated to protect clients,
employees, taxing authorities, insurers and the PEO industry. Ensuring financial responsibility
and solvency is just as important in regulating PEOs as it is for banks and insurance companies.

This is not about establishing a barrier to entry, because the PEO industry provides valuable
benefits to its business clients and employees. It is about establishing a reasonable threshold for
entry and a right to continue operations in a manner that protects the public.

I have been associated with the PEO industry for almost 40 years, first as a PEO owner and
officer/director of the national PEO industry trade association and then as CEO of ESAC and
also as a PEO client and employee. I have seen many unexpected PEO failures occur involving
both small and large firms. Every PEO failure that I have seen was directly the result of either:
(a) insufficient capitalization coupled with poor management decisions regarding pricing, credit
risks or excessive expansion into too many markets without the resources to sustain operations
when something went wrong; or (b) employment tax or insurance-related arbitrage or fraud.

ESAC has been successful in preemptively detecting these problems for 18 years without a
single accredited PEO default. In several cases, when ESAC declined accreditation to a PEO
applicant for financial reasons, the PEO failed within 1 to 3 years while being registered or
licensed in good standing in multiple states on the date of failure.

The vast majority of PEOs are owned and operated by honest people just as is the case with banks and insurance companies. But thresholds to entry and the right to continue to operate must be based on requirements that will preemptively detect the unqualified operators.

It is imperative that PEOs be required to provide reliable financial statements prepared in accordance with generally accepted accounting principles (GAAP). PEOs must be able to demonstrate positive working capital and positive net worth in an independently verifiable manner in order to provide a basic level of protection to the end consumer. Requiring audited financial statements is the only reliable and cost effective way to provide the Department with assurance that the financials received are free from material error, and that a PEO's working capital and net worth have not been materially overstated, whether due to error or fraud.

Additionally, financial statements require a number of estimates related to future and unknown events that can dramatically influence a PEO's reported financial position. It is important that an independent auditor verify that these estimates are reasonable and adhere to GAAP.

For example, it is common for PEOs to share in the risk of their workers' compensation insurance plans or to assume responsibility for other employer liabilities. If PEOs do so, GAAP requires the PEO to make estimates of future liabilities in order to demonstrate their ability to settle these liabilities as they become due. It is easy to see if a PEO were to drastically understate this estimated liability, its financial strength would be overstated, offering the Department no warning of the PEO's potential for financial distress. Requiring audited financial statements will ensure that these estimates have been reviewed by an independent auditor, and that, based on the auditor's independent and expert opinion, the estimates are reasonable and adhere to the relevant accounting standards.

Likewise, a reasonable bonding requirement has more protective value than the tangible value of the bond. A bonding requirement will ensure a surety underwriter independently verifies the PEO's financial reliability at least annually. Surety underwriters are trained to approach the evaluation of an applicant's financial condition with the goal of avoiding a financial loss. This underwriting process, coupled with the annual audit by an independent CPA, will provide the Department with a reasonable basis for confirming the financial reliability of PEO applicants for registration.

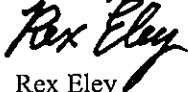
ESAC has been verifying PEO financial reliability for 18 years without a single default by an accredited PEO or a single claim against the \$40 million of surety bonds that ESAC holds in a national bank trust on behalf of its covered PEO clients and employees. The PEOs covered by ESAC's program have ranged from new startups, to small local or regional companies, to large national companies. Together accredited PEOs make up over 50% of the total PEO industry service volume.

During the past 18 years, ESAC has analyzed the financial statements and verified the state and federal regulatory compliance of a large number of PEOs of all sizes from new startups to national companies. During that time ESAC would have experienced the unexpected failure of a significant number of PEOs involving millions of dollars of losses had we not required audited financial statements covering all PEO entities under common ownership control, as well as the independent evaluation of these financial statements by an experienced surety underwriter, along with ESAC staff.

With respect to your efforts to improve HI's PEO law, ESAC respectfully requests that you also consider the fact that ESAC is currently providing PEO Assurance Organization and Electronic Compliance Reporting services to 14 other states, including the Departments of Labor in Colorado, Connecticut and Nebraska. ESAC would welcome the opportunity to work with you and HI's Department of Labor to make your PEO registration process more efficient and less burdensome. These services are available at no cost to the State and can be customized to meet your requirements.

I hope you find this information helpful as you strive to create the best possible PEO law and regulatory structure for Hawaii. If you would like to discuss this further, ESAC will be glad to help.

Sincerely,



Rex Eley
President & CEO, ESAC



February 7, 2013

The Honorable Rosalyn H. Baker, Chair
The Honorable Brickwood Galuteria, Vice Chair
Committee on Commerce and Consumer Protection
State Capitol
Honolulu, Hawaii 96813

Subject: SB 813, February 8, 2013, 9:00am, CR229
Strong Opposition

Dear Senator Baker and Senator Galuteria:

My name is Barron Guss, President and second-generation owner of ALTRES, Inc., a 43-year old Hawaii company and Hawaii's oldest Professional Employer Organization (PEO). I am writing you today in strong opposition to SB813.

The authors of SB 813 would like you to believe that the current law (Act 129) regulating PEO activities in the State is over-burdensome and not needed. They claim that there are more than ample controls in place to ensure consumer protection via current law and regulation, as well as oversight by DLIR and insurance carriers, which is simply not true. On a federal level, there are no statutes in place that regulate the PEO third party employer relationship. Hence, that is why 39 other states, in addition to Hawaii, have passed registration, bonding and audit requirements similar to Act 129.

Laws and regulations regarding licensing and consumer protection are created to protect the public and provide a reasonable expectation that the person or entity that holds themselves out to be professional is qualified to do so. Whether it is a physician, CPA, hair stylist, financial institution or PEO, not everyone will qualify. Act 129 is doing what it was designed to do -- create a *threshold of entry* into the industry and not an "*anti-competitive*" barrier, as suggested by those seeking its repeal.

The PEO industry in Hawaii touches more than 25,000 Hawaii employees for the purposes of payroll, health benefits and taxes, and controls more than \$1 billion in associated monies. For this legislature to repeal the modest oversight of the current law which has barely had time to take effect would be irresponsible. This would be similar to introducing legislation to remove banking regulation and the FDIC.

The proponents of SB 813 further justify this legislation because they claim the payroll industry moves similar amounts of money yet goes unregulated. Again, this is simply not true. In the client payroll service bureau relationship there is federal oversight via the Reporting Agent authority by which a client company turns over payroll, taxes and associated monies to be remitted by the Reporting Agent. Once the client turns over the monies to the Reporting Agent in good faith, the IRS holds the Reporting Agent responsible in the event of default.

On the other hand, the PEO relationship has no such federal regulation and relies on the State governments to provide the much-needed consumer protection and clarification in this area. The PEO industry falls through the cracks because we are not a payroll agent, nor are we an insurance company or a bank that has their own regulatory bodies.

In addition to some housekeeping items including grammatical changes and clarifications, the balance of SB 813 addresses the complex subject of successor employers for UI purposes. I would urge the committee to refrain from making any decisions about this area of the law, as unemployment insurance, rate promulgation and its funding have far-reaching effects and deserve a separate bill and discussion.

For the purpose of providing an in-depth understanding, I have provided some additional information below.

Background

The PEO industry originated on the mainland in the 1970s and found its way to the islands via my firm, ALTRES, in 1980.

PEOs are businesses that partner with existing small businesses (employers) to enable them to cost-effectively outsource the management of human resources, payroll, employee benefits and workers' compensation so that PEO clients can focus on their core competencies to maintain and grow their businesses.

An added benefit is that by forming an employment relationship with these small businesses and their employees, PEOs are able to offer enhanced access to employee benefits while saving money for both the business and the employees.

Legislative Background

Upon the industry's inception, Hawaii's employment and general excise tax laws did not match the operational needs of the industry. One example is that under the G.E.T., our clients' payroll monies, taxes and insurances, when passed through the PEO, were subject to 4% general excise tax, while our service fee was only 3%. In other words, the tax outstripped any fee income we were to earn on the transaction. The only way to remedy this was through legislation. For 16 years, I and others worked tirelessly with the legislature, various administrations, along with their tax directors and attorney generals, to finally get appropriate relief through the implementation of Act 225 in the 2007 legislative session.

PEO Failures

Throughout the history of the PEO industry, there have been multiple failures on a national level. Some states, like Florida, are very dense with PEOs, where at one time approximately 80% of the population in Bradenton County was employed through a PEO. This was because PEOs were able to bring financial relief to businesses in crisis in the areas of high workers' compensation premiums and unattainable health insurance. Many of those fledgling PEOs got

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in over their heads and could not deliver on their promises and, in some cases, mismanaged the affairs and monies of their client companies. Some of these failures were actual fraud and some were simply the result of naiveté regarding the complexities of running a PEO. It was not uncommon to hear of PEOs losing multiple tens of millions of dollars, closing their doors in the middle of the night and leaving town with trails of unpaid taxes and insurance premiums in their wake.

Hawaii had one such close call about four years ago when a mainland PEO commenced business here through an unscrupulous local agent who committed fraud and stole \$2 million of tax and insurance money that was to be paid to the federal and Hawaii state government. It was fortunate that the mainland PEO understood the local ramifications of the situation and quickly made restitution.

From the above illustration, you can see the need for regulation in this industry.

In the ensuing years, various issues arose, including some consumer protection questions that were handed down from national bodies such as NCOIL (National Council of Insurance Legislators) and others. It was agreed by members of the legislature (with concerns), DLIR, DOT, DOI, DCCA and others that the industry should pursue registration with consumer protection components similar to what has been implemented in 39 other states.

In 2010, the legislature enacted Act 129, the PEO Registration Act, which provides for registration and bonding requirements, under the supervision of the Department of Labor, to be implemented on July 1, 2011.

Current Status

Today DLIR estimates that there are approximately 40 PEOs operating in the state. Of this number, more than half are mainland based. Of the locally based PEOs, only six are registered with the Department of Labor, with the balance failing to file, either under protest of the law or claiming that the bond and audit requirements are too costly.

Specifically, the contested components of the current law are the bond amount and the audit requirement. Let me address these items below:

Bond

The initial introduction of the PEO Registration Act required a \$1 million bond, and through deliberation, testimony, collaboration and compromise, the current \$250,000 level was decided upon because of a mutual concern that the \$1 million bond would create a barrier to entry into the market for small and start up PEOs.

It is important to note that a \$250,000 bond does not cost \$250,000. Traditionally, a bond requirement would be met by applying to a surety carrier and paying a nominal percentage of the face value of the bond. For example, ALTRES pays \$1,700 per year to meet the \$250,000 requirement of the law.

The idea of posting a bond is not so much about the amount of the bond as it is the process and due diligence of the surety who posts the bond on behalf of the business. The surety process is a very thorough and complex one in which the underwriters will review every financial aspect of the business as well as background information of the principles and the overall condition of the organization. As you can imagine, this is a very arduous undertaking not only for the surety underwriter, but the PEO registrant as well.

Nationally, the trend is for \$50,000 to \$100,000 bonds as well as net worth requirements. I believe this number is simply too low because it is very easy for the average business operator to arrange assets in a way to post this moderate amount and forego the scrutiny of the bond process. With the number at a more business-like amount of \$250,000, a PEO operator will look to the financially viable process of purchasing a bond from a surety with a moderate cash outlay as compared to tying up \$250,000 in cash. This path of bond posting provides an additional level of consumer protection.

Audit requirements

The current law requires PEOs to maintain audited financial statements under GAAP, which is not uncustomary for any organization that is in the financial sector, which PEOs are. Opponents have said that this is burdensome for a number of reasons.

There has been testimony that audited financial statements are too costly for these small businesses. Fees for an independent audit are scaled according to the size of the business. A small PEO with relatively simple accounting, as compared to a large one, could pay as little as \$5,000 a year. The benefits of this audit to the PEO operator are many, including an understanding of cash flow, long term debt and the effect that unforeseen circumstances can have on their business. It is important to note that the current law is not giving the DLIR intrusive access or even oversight into the operations of the business. Instead, the PEO operator employs their own CPA/auditor to provide this valuable insight into the operation and financial health of their business. It provides the PEO operator comfort in knowing whether or not they are doing things right. Because many small PEO operators most likely do not have the staff on hand with credentials to maintain strong internal controls, it becomes even more important for them to hire an independent auditor.

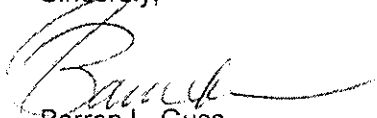
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In Conclusion

Although not perfect, the current law provides a strong foundation to ensure proper oversight. A small handful of PEOs should not be allowed to ignore the law just because they don't agree with it. Allowing them to do so sends the wrong message to all law abiding citizens.

I urge this legislature to allow the current law a chance to take effect and do what it was designed to do.

Sincerely,

A handwritten signature in black ink, appearing to read "Barron L. Guss", with a long horizontal flourish extending to the right.

Barron L. Guss
President and CEO

BLG:lo



**Testimony to the Committee on Commerce and Consumer Protection
Friday, February 8, 2013
9:00 a.m.
Conference Room 229**

**RE: SENATE BILL 813 RELATING TO PROFESSIONAL EMPLOYER
ORGANIZATIONS**

Chair Baker, Vice Chair Galuteria, and Members of the Committee:

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. Because of our belief that our clients deserve the peace of mind that they have contracted with 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.

II. SB 813

- The current PEO registration law, HRS 373L is a consumer protection law; protecting Hawaii's businesses and our working families who depend on PEOs for payroll, health care, workers' comp coverage, and temporary disability insurance.
- SB 813 seeks to repeal the fundamental elements of current registration law, including the security bond and financial audit.
 - o A surety bond is needed to protect consumers and the State from poor business practices by a PEO. Maintaining a bond will ensure that PEOs act in the best interest of their Client Companies. In the event that a PEO does not act in the best interest of consumers, for example, collecting workers' compensation insurance premiums but not remitting the premiums to an insurance carrier and a claim is incurred, both the consumer and the State may be indemnified by the bond, and therefore, allowing the injured worker to receive workers' compensation coverage. A bond keeps PEO clients and their employees safe in the event the PEO engages in unlawful business practices.
 - o The bond requirement in HRS 373L is reasonable and is not anti-competitive to smaller PEOs. For example, ProService Pacific, LLC 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.
 - o 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.
- SB 813 also attempts to **eliminate** requirements that PEOs, as a condition of doing business in Hawaii provide proof of coverage for: of: (1) workers' compensation; (2) Temporary Disability Insurance; (3) Prepaid Healthcare; and Unemployment Insurance. These are requirements of the current law, HRS 373L, and requirements for every business. It appears the proponents of this bill are asking that the state be more lenient on PEOs than other businesses or employers. Therefore, we believe that as a requirement to do business, PEOs should maintain a Certificate of Compliance – proof of Workers' Compensation Insurance, TDI, Prepaid Healthcare, and tax clearance per HRS 373L as this assures the State and the Client Companies of the PEO that standard requirements are adhered to.

- We recommend that the legislature allows the current law, HRS 373L to be fully implemented before taking any action on new PEO registration bills. Many PEOs are in compliance with 373L, 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.
- The Bill attempts to amend how PEO clients should be treated under our state unemployment insurance laws. This provision is misplaced in a PEO registration bill and we defer to the DLIR UI Division for their opinion before providing our comments.
- SB 813 House companion bill is HB 144. Based on the actions of the House Labor Committee replacing the language of HB 144 with language of SB 510 we respectfully ask the committee to hold SB 813.

Thank you for the opportunity to submit testimony.