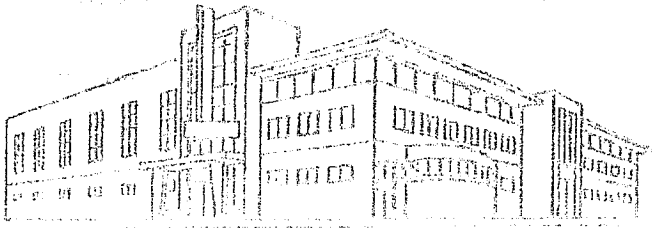


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Carpenters' Testimony on House Bill 2135 An Act relating to misclassification of employees

The bill before you today, in repealing key elements of the employee misclassification law enacted in 2006, threatens to strip the Kansas Department of Labor and Kansas Department of Revenue of what are the most effective weapons in their arsenal to combat the scourge of worker misclassification in our State.

Specifically, the bill would eliminate the tax penalties that may be levied against an employer who *knowingly and intentionally* misclassifies workers to avoid its obligation to pay State taxes or unemployment insurance contributions. In addition, the bill would prohibit the Secretary of Revenue from sharing taxpayer information with the KDOL about

employers suspected of misclassifying workers to allow the KDOL to investigate these employers to determine if, in fact, they are in compliance with State reporting requirements.

If this bill passes, unscrupulous employers will have little incentive to properly report the wages of or withhold taxes from their employees in the future. The tax penalty provided for in the 2006 act serves as an effective deterrent to those employers who would otherwise be willing to deprive the State of legally required payroll and withholding taxes.

In addition, the bill would hobble the efforts of the KDOL and KDOR to jointly investigate and audit suspected misclassifiers. By all accounts, the agencies' collaborative enforcement program has been a success. For example, according to data released by the State, in 2010 alone KDOL investigated over 290 employers regarding the misclassification of over 1800 employees which resulted in finding more than \$5.4 million in previously unreported wages. By taking away the agencies' capability to share confidential taxpayer data, this bill would lead to unnecessary duplication of audits and other efforts—inefficiencies that will cost the State needless additional expense.

Why would this Committee even consider doing away with the collaborative enforcement program after the success it has had? And why would this Committee even consider waiving tax penalties for employers who are *knowingly and intentionally* evading their tax-withholding obligations?

What is Worker Misclassification?

Kansas employers are required to report wages of its employees to the Department of Revenue and the Department of Labor for the purposes of Withholding Tax, Unemployment Tax, and Workers' Compensation. Worker misclassification occurs when workers who should properly be classified as employees are instead classified as independent contractors. Misclassification wrongfully deprives the State of Kansas of payroll and withholding taxes that are required to be paid by employers on their employees—tax revenue the State can ill-afford to forego as it struggles to fund its budget. The deliberate misclassification of employees to avoid payment of taxes unfairly disadvantages the overwhelming majority of Kansas employers who obey the laws and pay their taxes.

The misclassification laws you are now considering repealing were enacted in 2006 to ensure a fair playing field for employers and protection for workers in our State.

A recent study conducted by the School of Industrial Labor Relations at Cornell University estimates that approximately 10% of workers reviewed from Department of Labor audits were misclassified. In the construction industry, the number of misclassified employees increased to 15%.

Although it is a serious problem, worker misclassification is not a new problem. In 1984, the General Accounting Office estimated that the Federal Government lost \$1.6 billion in tax revenue due to employee misclassification. *That's \$1.6 billion.* Additionally, the number of independent contractors has been on the increase for more than twenty years. For one three-year period, 1985 to 1988, the General Accounting Office reported a 53%

increase in the number of individuals who filed their taxes as either self-employed or independent contractor.

So why do businesses misclassify workers? The harsh reality is that *businesses have an economic incentive to misclassify*. Think about it. Businesses that misclassify employees as independent contractors have significantly lower overhead than law-abiding businesses. If a business employs independent contractors, that business does not have to pay unemployment insurance contributions, workers compensation premiums, or social security tax on those independent contractors. These "add-on" costs make hiring an employee 26-30% more expensive than hiring an independent contractor.

Additionally, businesses do not pay any sort of health insurance benefit to independent contractors. According to the Kaiser Family Foundation Health Benefit Annual Survey, in 2006, the average annual premium for an employer health plan covering a family of four was \$11,500.00. Small employers with less than twenty-four workers saw a 10.5% increase in premiums during 2006. These costs are continuing to increase and create a substantial burden on law-abiding employers that properly classify their employees and provide benefits to those employees.

Worker misclassification is not a victimless crime. A myriad of harms stem from misclassification. These harms include harm to law-abiding businesses, harm to the misclassified workers, and harm to the State.

Solid, law-abiding businesses which properly classify employees and offer health benefits to those employees are at a competitive disadvantage when competing directly

against companies which wrongfully classify their employees as independent contractors. The problem is particularly noticeable and rampant in industries like the construction industry, where companies bid for jobs. There can never be a fair and competitive bid process when companies that misclassify can bid for work without having to account for normal payroll costs. The misclassifying company will always have the lower bid and will be able to take work away from the law-abiding company. The result is that the "good" companies receive fewer jobs, employ fewer workers, and may eventually be driven out of business.

Not only does misclassification harm law-abiding businesses, it also harms the misclassified workers themselves. When employees are not properly classified, costs that should be borne by the employer (such as unemployment insurance, social security tax, and workers compensation insurance) are illegally shifted to the individual worker. If the individual worker pays out of pocket for these costs, the worker has less money available for basic living expenses. As a result, many workers do not make contributions to the unemployment, social security or workers compensation systems and are left with little to no safety net in the event of layoff or on the job injury.

Employees misclassified as independent contractors additionally lack the benefit of company-provided benefits such as health insurance and a retirement plan or 401(k). Many are either unable to qualify for individual health insurance or unable to afford the premium for individual health insurance. With no health insurance, and no retirement savings, these workers are stuck in a grim situation from which there is no escape. They work every day

praying to avoid injury and cannot see a time when retirement could be possible. If one of these workers is injured on the job and disabled, the cost for supporting that worker and his family falls back on the state public assistance programs.

This is but one impact of worker misclassification borne by the State. State finances regularly fall victim to employee misclassification. The University of Missouri-Kansas City conducted a study on the economic costs of misclassification in the state of Illinois. The study found that *during every year from 2001 through 2004, the state lost \$39.2 million in unemployment taxes due to worker misclassification. During 2005, this number grew to \$53.7 million. The state only managed to recover approximately 2% of the unpaid amount.* Of the unpaid unemployment insurance amounts in 2005, \$2.5 million was the result of misclassification in the construction sector.

States also collect less income tax from independent contractors. According to the IRS, *workers classified as independent contractors report only 68% of their income (as opposed to employees, who report 99% of income).* As such, *when a worker is misclassified, the state collects taxes on 31% less income than the worker actually earns.*

Conclusion

Worker misclassification takes a heavy toll on law abiding companies, misclassified workers, and the State of Kansas. This bill will exacerbate the problem of misclassification by taking the "teeth" out of the 2006 misclassification law, tying the hands of the KDOL and KDOR agents who are charged with enforcing our State's employment laws. The penalties

and the inter-agency partnership need to be retained, because they remain our most effective methods for fighting worker misclassification. It is in the best interest of business, workers, and the State to stop deliberate employee misclassification. And the best way to do that is by leaving the existing law unchanged. We urge you to defeat this bill. Thank you.

Respectfully,



Joe Hudson

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