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February 8, 2011

House Commerce and Economic Development Committee

Testimony Concerning House Bill 2135

Presented by Richard Cram

Chairman Anthony Brown and Members of the Committee:

House Bill 2135 would repeal K.S.A. 44-766, which states that any person who knowingly misclassifies an employee as an independent contractor solely to avoid state income withholding tax requirements or state unemployment insurance contribution reporting requirements is subject to penalty pursuant to K.S.A. 79-3228, the penalty and interest statute applicable to state income or employer withholding tax. House Bill 2135 would also strike certain language in K.S.A. 2010 Supp. 79-3234(b)(13) that enables the Department of Revenue and the Department of Labor to exchange taxpayer information concerning withholding and other payroll taxes in order to facilitate enforcement of K.S.A. 44-766 and the employer payroll withholding laws. The Department's fiscal note is attached.

K.S.A. 44-766 and the language at K.S.A. 2010 Supp. 79-3234(b)(13) were enacted in 2006 House Bill 2772 to facilitate cooperation between the Departments of Revenue and Labor in the enforcement of the employer withholding tax laws administered by the Department of Revenue and the unemployment insurance and workers compensation insurance coverage laws administered by the Department of Labor.

Passage of House Bill 2135 would end the ability of the two agencies to cooperate with taxpayer information exchange in such investigations. An employer found to have improperly failed to withhold employer payroll taxes will still be subject to applicable penalty and interest provisions under K.S.A. 79-3228, but the two agencies will not be able to exchange the information needed to facilitate identifying such an employer.

Since enactment of 2006 House Bill 2772, the Departments of Labor and Revenue have cooperated in exchanging leads on employers who may be misclassifying employees as independent contractors to evade their responsibilities to report state withholding tax on wages, as well as payment of unemployment insurance tax and workers compensation insurance premiums. Department of Labor makes the determination of whether someone is properly classified as an employee or an independent contractor. The determination of an employer-

employee relationship triggers the employer's responsibility for employer withholding tax on wages, as well as payment for unemployment insurance tax and workers compensation insurance premiums. When the Department of Labor informs Department of Revenue compliance staff of misclassification situations, Department of Revenue can then pursue enforcement of unreported employer withholding tax liability against those employers.

Since January 2008, as a result of inter-departmental cooperative efforts, Department of Revenue compliance staff have investigated 411 misclassification cases for withholding tax evasion involving \$3,179,144.36 in total wages (89 of those cases began as referrals from the Department of Revenue to the Department of Labor), resulting in assessments of \$1,563,939.61 for unreported withholding tax. Our Audit Services Division has completed 130 withholding tax audits arising from these cases, recovering payments of \$901,037.

Department of Revenue compliance staff recently (December 2010) received new information from Department of Labor concerning an additional 543 businesses determined to have misclassified workers. The Department of Revenue is currently investigating these businesses regarding compliance with employer withholding tax requirements. Assessments will be issued to those businesses failing to properly report and remit withholding tax.

The Departments of Labor and Revenue have established a joint website where members of the public can learn about employer misclassification and file complaints concerning suspected violations. The link to that site is at <https://www.kdor.org/misclass/mcfaq.htm>. Complaints filed on the website are routed first to the Department of Labor for investigation. Misclassification violation information can then be turned over to Department of Revenue for follow-up investigation of any withholding tax violation. Attached is a list of frequently asked questions shown on this website.

**2011 House Bill 2135b** Revised Fiscal Note  
Introduced as a House Bill

**MEMORANDUM**

**To:** Mr. Steve Anderson, Director  
Division of Budget

**From:** Kansas Department of Revenue

**Date:** 02/08/2011

**Subject:** House Bill 2135  
Introduced as a House Bill  
Revised Fiscal Impact

**Brief of Bill**

House Bill 2135, as introduced, amends K.S.A. 79-3234 by eliminating the provision that allows the department of revenue to share taxpayer information with the department of labor regarding employee withholding and payroll information.

The bill also eliminates K.S.A. 44-766 which states that no person shall knowingly and intentionally misclassify an employee as an independent contractor for the purpose of avoiding state withholding or state unemployment insurance.

The effective date of this bill is on publication in the statute book.

**Fiscal Impact**

Passage of this bill will have a negative but unknown impact on state general fund revenues.

Employers currently are required to report income paid to an employee or an independent contractor. Employers are required to issue a w-2 to all employees and 1099's to anyone not considered an employee.

Since 2008, audits arising from information exchange between the Departments of Revenue and Labor have resulted in about \$900,000 in withholding tax collections, or about \$300,000 per year. This amount includes the tax plus any penalties and interest due.

**Administrative Impact**

None.

**Administrative Problems and Comments**

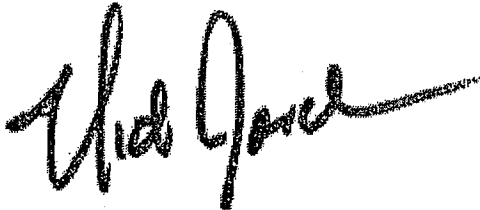
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Without statutory authority to exchange information concerning suspected misclassification violators, the Department of Revenue and Department of Labor will no longer have the ability to cooperate in such investigations.

**Taxpayer/Customer Impact**

**Legal Impact**

Approved By:



Nick Jordan  
Secretary of Revenue

## What is the misclassification of workers?

Misclassification of workers occurs when an employer incorrectly classifies workers as independent contractors rather than employees.

### Why is it important to correctly classify workers?

An employer has different legal, tax and financial obligations depending on how a worker is classified. For example, if a worker is classified as an **employee**, the **employer** is required to:

- withhold income, F.I.C.A. (Social Security) and Medicare taxes from the employee's wages;
- pay F.I.C.A. (Social Security) and Medicare taxes in addition to the employee's share;
- pay unemployment taxes (which provides insurance coverage in case the worker is laid off); and
- buy workers compensation insurance (which provides insurance coverage in case the worker is injured on the job).

If a worker is classified as an **independent contractor**, the employer generally does not have those obligations and the **worker** is required to:

- make quarterly estimated payments for income taxes, and;
- pay self employment taxes.

An independent contractor is not entitled to unemployment compensation and, in many cases, will not receive workers compensation if injured on the job.

**Most importantly, the intentional misclassification of workers is illegal and constitutes tax and insurance evasion. Employers engaging in this practice may be subject to significant penalties and fines.**

### What is employment?

Employment is defined in K.S.A. 44-703, Chapter 44, Article 7. According to this statute, employment means:

- Services performed by an individual for wages under any contract of hire is employment unless it is shown that:
    1. The individual has been and will continue to be free from control or direction over the performance of the services, both under the individual's contract of hire and in fact;
- AND**
2. The service is either outside the usual course of the business for which the service is performed or that the service is performed outside of all the places of business of the enterprise for which the service is performed.

### Who is an employee?

An **employee** is anyone performing services for an employer who controls what will be done and how it will be done by the worker. This is true even if the employee has freedom of action. What matters is the right of the employer to control the details of how the services are performed.

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**Who is an independent contractor?**

**Independent contractors** have an independent trade, business, or profession. They offer their services to the public and are generally not employees. However, whether they are employees or independent contractors depends on the facts in each case. The general rule is that an individual is an independent contractor if the employer controls or directs only the result of the work and not the means and methods of accomplishing the result.

**Who determines if a worker is an employee or an independent contractor?**

The Kansas Department of Labor is responsible for investigating worker classification by employers.

**How does the Kansas Department of Labor determine if a worker is an employee or an independent contractor?**

The right of control, whether or not exercised, is the most important factor in determining the relationship. An employer-employee relationship exists when an employer has the **right** to exercise control over the manner and means by which the individual performs services. The right to discharge a worker at will and without cause is strong evidence of the right of direction and control. The following factors should also be taken into consideration:

- Is the one performing the services engaged in a separately established occupation or business?
- Is the work usually performed without supervision in that locality?
- What skill is required in performing the services and accomplishing the desired result?
- Who supplies the tools, equipment, and place of work for the person doing the work?
- Is the performance of services an isolated or continuous event?
- What is the method of payment, whether by time, a piece rate, or by the job?
- Is the work part of the regular business of the employer?
- What is the extent of actual control exercised by the employer over the manner and means of performing the services?
- Are the services performed for the benefit or convenience of the employer as an individual or for the employer's business enterprise?
- Can the worker make business decisions that would result in a financial profit or loss for the worker? Investment of the worker's time is not sufficient to show a risk of loss.

A written contract that claims to create an independent contract relationship is worthless if the practice of the parties shows that the employer retains the right to control the means and manner in which services are performed.

Generally an employer-employee relationship is found to exist when the work being done is an integral part of the regular business of the employer and the worker does not furnish an independent business or professional service to the employer.

**What difference does it make if workers are misclassified?**

A business that intentionally misclassifies employees creates a number of costs for a variety of people. The costs avoided do not go away, they are simply borne by other people.

- A worker misclassified as an independent contractor rather than as an employee suffers several adverse consequences. The worker is responsible for payment of income and self-employment taxes. Self-employment taxes are a higher cost for the worker because self-employment taxes include a portion of the F.I.C.A. (Social Security) and Medicare taxes that would have been paid by the employer.

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If laid off from a job, the misclassified worker must bear the financial consequences and is usually not entitled to unemployment compensation.

If injured on the job, the misclassified worker is often not entitled to workers compensation benefits and must pay medical expenses and bear the financial burden of lost income.

- Businesses that intentionally misclassify workers put other businesses at a competitive disadvantage.
- In the end, honest Kansas taxpayers must pick up the remaining cost.

### **How can I report employment misclassification?**

You can report suspected misclassification to the Department of Labor and Department of Revenue on this website. The Departments will investigate all reports submitted via this website.

<https://www.kdor.org/misclass/MisclassForm.aspx>

### **What are the penalties that an employer maybe subject to if the employer misclassifies a worker?**

#### **Unemployment Taxes**

K.S.A.44-117 states: (a)(1) Penalties on past-due reports, interest on past-due contributions, payments in lieu of contributions and benefit cost payments. Any employer or any officer or agent of an employer, who fails to file any wage report or contribution return by the last day of the month following the close of each calendar quarter to which they are related shall pay a penalty as provided by this subsection (1) for each month or fraction of a month until the report or return is received by the secretary of labor. The penalty for each month or fraction of a month shall be an amount equal to .05% of the total wages paid by the employer during the quarter, except that no penalty shall be less than \$25 nor more than \$200 for each such report or return not timely filed.

Contributions and benefit cost payments unpaid by the last day of the month following the last calendar quarter to which they are related and payments in lieu of contributions unpaid 30 days after the mailing of the statement of benefit charges, shall bear interest at the rate of 1% per month or fraction of a month until payment is received...

K.S.A. 44-719 states:

(e) Any employer or person who willfully fails or refuses to pay contributions, payments in lieu of contributions or benefit cost payments or attempt in any manner to evade or defeat any such contributions, payments in lieu of contributions or benefit cost payments or the payment thereof, shall be liable for the payment of such contributions, payments in lieu of contributions or benefit cost payments and, in addition to any other penalties provided by law, shall be liable to pay a penalty equal to the total amount of the contributions, payments in lieu of contributions or benefit cost payments evaded or not paid.

#### **Worker Compensation**

K.S.A. 44-5,120 states: (d) Fraudulent or abusive acts or practices for purposes of the workers compensation act include willfully, knowingly or intentionally: (2) misrepresenting to an insurance company or the insurance department, the classification of employees of an employer, or the location, number of employees, or true identity of the employer with the intent to lessen or reduce the premium otherwise chargeable for workers compensation insurance coverage.

Essentially, it is considered a fraudulent act to represent employees as a different classification for the purpose of obtaining a cheaper premium.

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With regard to penalties, K.S.A. 44-5,120(g) provides for a couple different options:

(g)(1) Payment of a monetary penalty of not more than \$2,000 for each and every act constituting the fraudulent or abusive act or practice, but not exceeding an aggregate penalty of \$20,000 in a one-year period.

(g)(2) Redress of the injury by requiring the refund of any premiums paid by and requiring the payment of any moneys withheld from, any employee, employer, insurance company or other person or entity adversely affected by the act constituting a fraudulent or abusive act or practice.

Based on the two penalty provisions listed above, an employer potentially could be charged according to the number of times he misrepresents an employee and/or the amount of premium that should have been paid had the employees been classified correctly. Determining what penalties to charge depends on the facts of each case.

**Withholding Tax**

Generally, every employer required by federal law to withhold upon wages pursuant to the federal internal revenue code shall, whenever the wage recipient is a resident of Kansas or the wages are paid on account of personal services performed in Kansas, withhold and deduct from such wages an amount to be determined in accordance with K.S.A. (2005 Supp.) 79-32,100d, and amendments thereto.

Employers who fail to withhold upon their employees' wages or otherwise fail to comply with the provisions of the Kansas Withholding and Declaration of Estimated Tax Act shall be subject to the penalty provisions set forth in K.S.A. 79-3228 and 79-32,107, and amendments thereto. Such penalties range from 1% per month of the unpaid balance of tax due up to 100% of the unpaid balance of tax due, plus interest on the unpaid tax at the rate established by law.