
Underground Economy Benchmark Report (RCW 18.27.800)

2014 Annual Report to the Legislature

November 2014

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Executive Summary

Introduction

This report is required by Substitute House Bill (SSB) 1555, adopted in 2009 by the Washington State Legislature based on the recommendations of the Joint Legislative Task Force on the Underground Economy. The law required, in part, that the departments of Labor & Industries, Revenue and Employment Security coordinate and report to the legislature by December 1 of each year on the effectiveness of their efforts to address the underground economy.

The underground economy is the loose network of businesses and individuals that do not register or do not report a significant part of their business activities with authorities. As a result, they not only fail to pay their fair share of taxes and workers' compensation premiums, but they gain an unfair advantage over competitors.

The three agencies providing this report are sharing data and collaborating in other areas to uncover and take action on tax misreporting and other forms of fraud. Even though the joint task force ended in 2009, the agencies remain committed to working together and sharing information to prevent fraud and reduce the effects of the underground economy.

Progress and Achievements in Fiscal Year (FY) 2014

The departments of Labor & Industries (L&I), Revenue (DOR) and Employment Security (ESD) shared their information on contractor registration, taxes and other electronic data to discover and hold accountable hundreds of players in the underground economy.

At the same time, the agencies assisted construction contractors and other business owners in meeting state requirements.

July 2013-June 2014 (FY 2014) activities

- Together, L&I, DOR and ESD:
 - Uncovered a combined total of approximately 1,789 unregistered businesses that were assessed \$44.9 million in unpaid taxes, premiums, penalties and interest.
 - Exchanged more than 36,000 tips and leads through electronic data matches.
 - Provided options for making late payments and information on the availability of interest and penalty waivers.
- ESD:
 - Found more than 6,400 unreported or misclassified workers through audits.
 - Assessed a total of more than \$605,000 on unregistered accounts.
- L&I:
 - Issued more than 1,200 infractions to unregistered contractors.
 - Collected \$153.2 million from delinquent employer premiums (while most of this amount was from standard collection activities and not the underground economy, this money helps keep rates low by ensuring all employers pay their fair share).
 - Performed 977 audits on unregistered accounts for over \$10 million assessed.

- Educated and trained more than 1,300 construction contractors through outreach events.
- Educated more than 34,000 consumers about their rights and how to hire legitimate contractors.
- DOR:
 - Collected over \$27 million through its Tax Discovery Program.
 - Registered more than 700 non-compliant businesses.
 - Assessed taxes totaling over \$34 million from 682 businesses.
 - Recovered over \$400,000 in fraud-related dollars.
 - Provided online outreach and assistance through SuspectFraud.com and led discussions on new and relevant ways to find leads in the underground economy.

When DOR, ESD and L&I find businesses or individuals that may need to be investigated, they notify the appropriate agency by sending referrals or sharing and cross-checking data. Figure 1 shows the number of referrals and data transfers from one agency to another made by inspectors.

Figure 1: Number of interagency tips and leads between DOR, ESD and L&I*

Referral from...to	FY 2012		FY 2013		FY 2014	
	Interagency referral form	Electronic data file transfers	Interagency referral form	Electronic data file transfers	Interagency referral form	Electronic data file transfers
DOR to L&I	20	25,993	30	20,174	0	20,024
DOR to ESD	30	22,778	16	20,174	57	20,024
L&I to DOR	18	11,587	16	10,895	135	10,930
L&I to ESD	4	13,292	22	13,730	95	14,672
ESD to L&I	33	14,522	0	13,388	0	*13,286
ESD to DOR	12	15,095	2	13,839	0	*13,286
Total	117	33,245	86	26,234	287	36,184

*Note: While the interagency referral form method shows as zero for both DOR and L&I, ESD does send all referrals generated through the underground-economy audit program to both agencies through the electronic data file method.

Source: Department of Revenue

Conclusion

The multi-agency effort to dismantle the underground economy will continue to be a critical mission for DOR, L&I and ESD. The agencies are strengthening their partnership by sharing information and meeting on a regular basis. They engage with stakeholders to identify problems and create new tools for achieving compliance. Enforcing Washington's laws and providing education and assistance will help level the playing field for employers and workers who already do their best to follow the rules.

Introduction

The underground economy is the loose network of businesses and individuals that fail to register or to report a significant part of their business activities with authorities. The result is that they not only neglect to pay their fair share of taxes and workers' compensation premiums, but they gain an unfair advantage over competitors.

The three agencies providing this report are sharing data and collaborating in other areas to uncover and take action on tax misreporting and other forms of fraud. Even though the joint task force ended in 2009, the agencies remain committed to working together and sharing information to prevent fraud and reduce the effects of the underground economy.

This report provides updated information about how the departments of Labor & Industries (L&I), Revenue (DOR) and Employment Security (ESD) shared information on contractor registration, taxes and other electronic data to discover and hold accountable hundreds of players in the underground economy during 2014.

Progress and Achievements in FY 2014

This section describes fiscal year (FY) 2014 progress and achievements of each of the three partner agencies (L&I, DOR and ESD) in working together to prevent fraud and reduce effects of the underground economy in Washington.

L&I HIGHLIGHTS

L&I protects the safety, health and security of Washington's workers and citizens. As part of this responsibility, the department is committed to helping honest workers, providers and businesses by cracking down on dishonest ones. FY 2014 highlights include:

- **Collections** – L&I collected \$153.2 million in delinquent employer premiums for workers' compensation insurance.
- **Improved audit selection** – Eighty-three percent of employers referred for audits were found to owe premiums. In FY 2004, 50 percent of employers referred for audit owed premiums.
- **Prosecution** – L&I investigated and referred six employer cases to the Attorney General's Office for criminal prosecution. The Attorney General's Office filed charges in five cases. One case remains under review. Prosecution results include:
 - A Seattle contractor pleaded guilty to second-degree, felony theft and two counts of unregistered contracting. The contractor was ordered to serve 30 days in jail for scamming homeowners who paid him thousands of dollars for home improvement projects that he never finished. He was ordered to repay his victims in King and Pierce counties \$51,659, and to pay court costs.
 - A Pierce County landscaper pleaded guilty to a gross misdemeanor charge of doing business without workers' compensation insurance and a felony count of false reporting by an employer. A Pierce County Superior Court judge ordered him to serve 364 days in jail, but suspended it on the condition of no more criminal violations. He also must be on probation for a year, pay more than \$4,500 in restitution and perform 240 hours of community service. Authorities were alerted to the case when a longtime employee was injured while working for Executive Lawn Care in October 2012. The worker told an L&I investigator that the owner threatened him and his family if he filed a claim with L&I.
- **Employer fraud and misreporting** – Misrepresentation penalties occur when employers misclassify or underreport employees for workers' compensation insurance. In FY 2014, L&I pursued 35 misrepresentation penalties, for a total of \$799,054.
- **Construction compliance** – Compliance inspectors issued 1,213 infractions to unregistered contractors.

Contractor registration enforcement

L&I protects consumers by registering construction contractors. To register, contractors must have a minimum level of bonding and insurance coverage. This allows some financial recourse for homeowners and suppliers who encounter problems with fraudulent or incompetent contractors. In addition, all contractors must have a valid Unified Business Identifier (UBI) number to register.

Figure 2: Active contractor registrations on June 30, 2014

Fiscal year	With UBI
2009	56,685
2010	53,993
2011	52,645
2012	51,492
2013	52,250
2014	52,755

Source: Department of Labor & Industries

L&I denies or suspends registration of contractors who do not comply with contractor registration laws and rules. During FY 2014, L&I suspended 25,856 contractors for the following reasons:

- Cancelled insurance: 15,938
- Cancelled bond: 7,435
- Unsatisfied judgments: 623
- Impaired bond: 18
- Outstanding contractor registration infractions: 9

Contractor penalties

L&I is committed to improving consumer protection and leveling the playing field for legitimate contractors. To do this, the department:

- Informs and educates consumers.
- Provides timely and customer-focused services, such as online renewals and insurance entry for agents.
- Actively enforces the law.

L&I tracks companies that violate registration laws, misrepresent payroll or employee hours or conduct business without an L&I certificate of coverage for workers' compensation insurance. In 2014, L&I's Construction Compliance Program issued 1,213 infractions to unregistered contractors. This program also can penalize individuals up to \$10,000 for submitting false information in an application to become a registered contractor. The program issued four of these penalties to contractors in 2014.

Contractors cited for failing to register can receive a reduced penalty¹ if they voluntarily register and get a bond and insurance within 10 days after the citation. In FY 2014, 356 unregistered contractors took advantage of that option.

Prevailing Wage Program

L&I's Prevailing Wage Program is an important part of the department's efforts to ensure fairness for legitimate contractors and employees. The program ensures workers on public-works projects receive the prevailing wage for their trade or occupation in their county.

Violations, strikes and debarments

When contractors commit certain violations, the Prevailing Wage Program can issue fines and "strikes." A strike is a notice of a violation of contractor registration, workers' compensation or prevailing-wage requirements. If a contractor does not pay his or her fine or receives additional strikes, the contractor may be "debarred." When contractors are debarred, they are not permitted to bid on public-works projects for one to two years or until fines are paid.

Under RCW 39.12.055 (prohibitions on bidding on future contracts), a contractor can be debarred from bidding on public-works projects for violating one or any combination of:

- Contractor registration law.
- Industrial insurance law for misrepresenting hours/premiums or failing to obtain a certificate of coverage.
- Apprenticeship law.

Strikes are reported under the law where the violation occurred, not in a combination category. For contractor registration and workers' compensation insurance, strikes are cumulative. For prevailing-wage law, only violations of the same type count toward debarment. During FY 2014, the program recorded 1,237 strikes and debarred 196 companies from bidding on public-works contracts. See Figure 3.

¹ RCW 18.27.340

Figure 3: Prevailing-wage strikes and debarments, FY 2014

Reason	Number of strikes	Number of debarments
Contractor registration violation	567	26
Industrial insurance violation	582	24
Contractor registration and industrial insurance violation	N/A*	84
Prevailing wage violation: failing to file wage report/false filing	87	62
Prevailing-wage violation: failing to pay prevailing wage	1	0
Total	1,237	196

*Strikes are not reported in combined categories. Refer to above explanation of RCW 39.12.055.

Source: Department of Labor & Industries

Contractor field enforcement

In 2011, L&I and business and labor representatives discussed ways to improve compliance with state laws. Due to stakeholder concerns that inspectors still lacked a presence in the field, L&I reorganized its construction inspectors in 2012 to be more effective in the field statewide. The department assigned 23 inspectors and three supervisors to three regional compliance teams. In 2013, L&I continued to build on this emphasis, developing new tactics and tools to get inspectors to the right place at the right time.

Today, compliance inspectors are L&I's eyes and ears in the field for all types of violations. They enforce plumbing and electrical laws, check contractor registrations and identify employers owing significant debt to L&I. They confirm worker counts, compare them with reported numbers and refer cases to auditors. They refer potential violations of workers' compensation, prevailing-wage and DOR rules and laws to the appropriate staff or agencies.

The underground economy does not operate on a 9-to-5, Monday through Friday schedule. Therefore, inspectors perform surprise compliance sweeps, visiting multiple jobsites over the course of a weekend. They conducted about 11 such sweeps in FY 2014.

Figure 4 shows the number of violations issued, contractors referred to collections and contractors referred for auditing.

Figure 4: Contractor Compliance Program results

Compliance action	FY 2010	FY2011	FY2012	FY 2013	FY 2014
Underground-economy violations issued	246	241	1,646	*2,494	1,846
Contractors referred to collections program	300	310	Unavailable	Unavailable	1,670
Contractors referred to audit program	696	546	1,303	1,401	1,488

Note: Results shown are for the entire Contractor Compliance Program, including the Detection and Tracking Unit and field inspectors. Before FY 2012, there were six full-time equivalent (FTE) inspectors doing field enforcement. In FY 2012, there were 23 FTE field inspectors. In FY 2013, there were 25 FTE field inspectors. In FY 2014, there were 22 FTEs made up of 21 field inspectors and one compliance supervisor.

*The 2013 report shows 1,743 underground-economy violations issued in FY 2013, which was actually the number of unregistered contractor violations issued. The correct number for all violations is 2,494.

Source: Department of Labor & Industries

Construction contractor education and outreach

The most recognizable activity in the underground economy happens in the construction industry. Contractors in the underground economy are typically either unregistered or underreport their workers’ compensation responsibilities. This allows them to avoid paying their fair share of taxes and premiums. Unregistered contractors present a risk to consumers and gain an unfair advantage over competing businesses that play by the rules.

L&I is committed to making it easy to do business with the department. This includes making contractor registration easy. L&I provides step-by-step instructions and explanations of laws and rules online. The department also partners with the building industry to offer training events, such as “Employer’s Introduction to L&I” workshops, contractor training days and specialized training events. In 2014, L&I provided eight contractor training days to more than 1,300 contractors statewide. A total of 539 people attended “Employer’s Introduction to L&I” workshops. See Figure 5.

Figure 5: Construction contractor education and outreach

Contractor training events	Average contractor attendance per event	Estimated number of contractors trained
10	130	More than 1,300
8	142	More than 1,100
9	125	More than 1,100
8	130	More than 1,200
8	162	More than 1,300

Source: Department of Labor & Industries

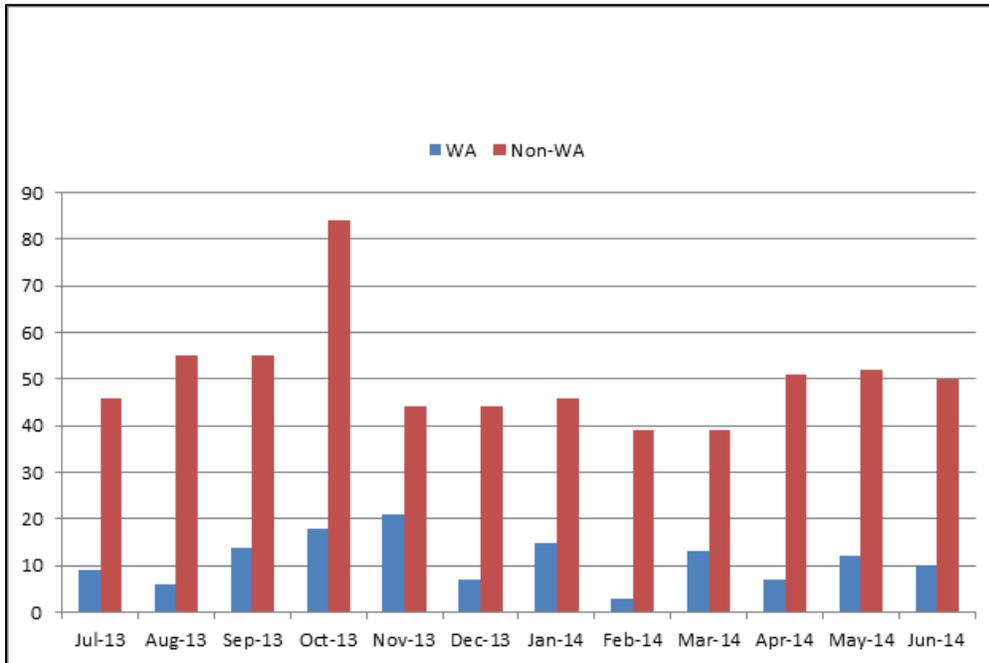
DOR HIGHLIGHTS

DOR's Compliance and Audit divisions continued to focus on both in-state and out-of-state unregistered businesses in an effort to address the underground economy. Both divisions investigate, assess and register non-compliant businesses.

In FY 2014, DOR registered 740 non-compliant businesses. Of those, 682 were found to owe taxes, and a total of \$34 million was assessed against them. This included:

- 89 in-state businesses assessed more than \$840,000.
- 593 out-of-state businesses assessed more than \$33 million.

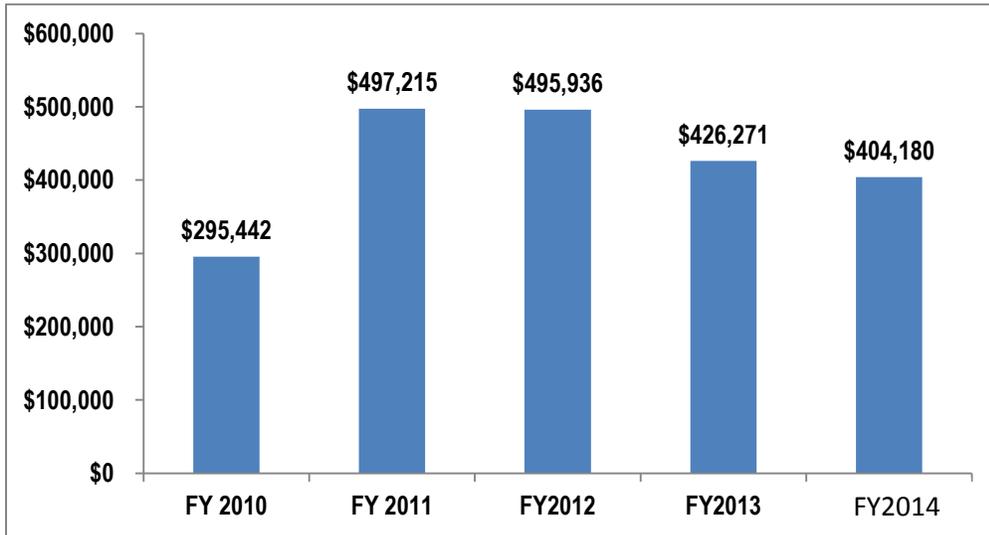
Figure 6: Number of businesses registered through tax discovery



Source: Department of Revenue

In addition to unregistered businesses, DOR’s Compliance and Audit divisions refer and investigate fraud cases. The Compliance Division investigates unlicensed vehicles, vessels and airplanes. DOR continues to focus on education and enforcement to reduce non-compliance and ensure a local presence is maintained.

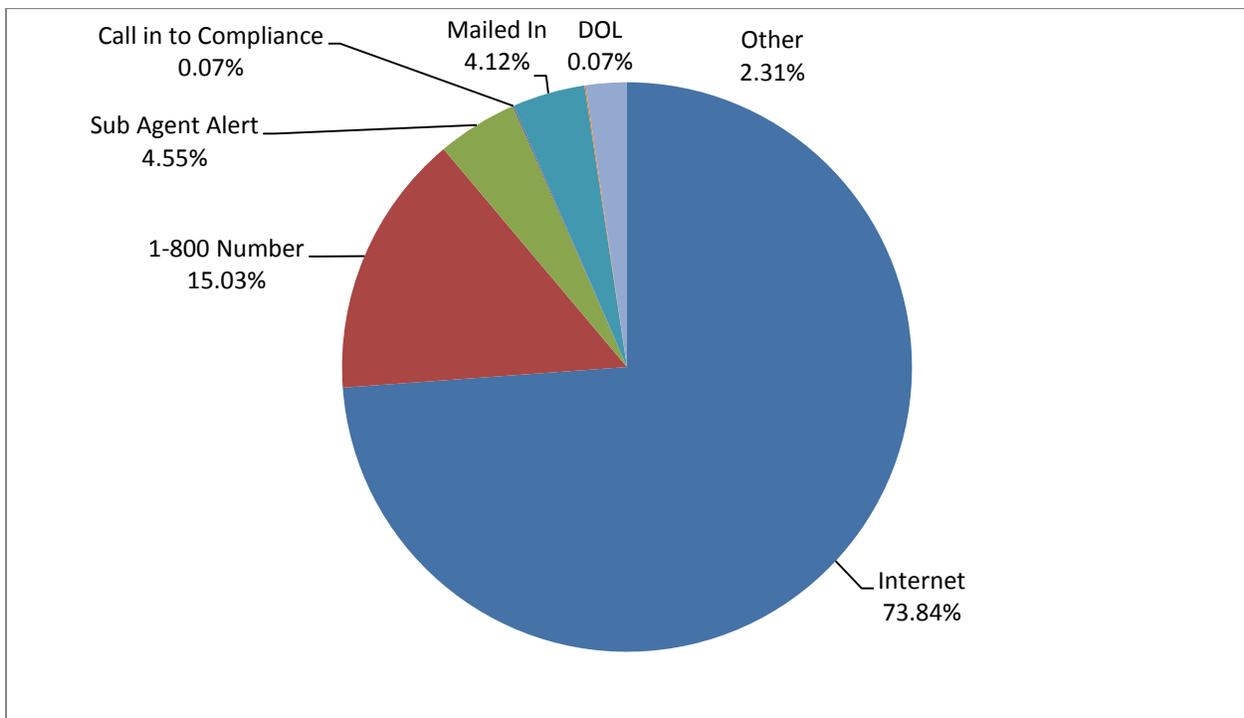
Figure 7: Fraud referral total dollars collected



Source: Department of Revenue

DOR has provided a variety of methods for making fraud referrals. This allows private citizens and other agencies to report cases where they believe fraud is being committed.

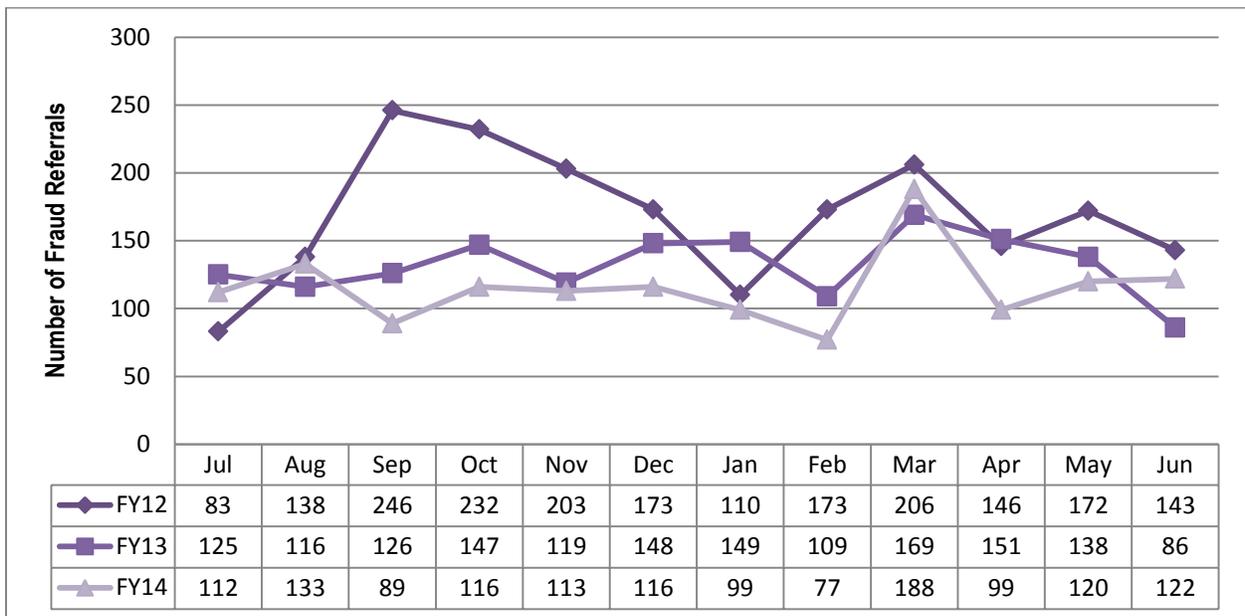
Figure 8: Fraud-referral sources, FY 2014



Source: Department of Revenue

In FY 2012, Internet referrals made up 65 percent of the fraud referrals received. This increased to 81 percent in FY 2013. In FY 2014, Internet referrals dropped to 74 percent, while calls to DOR’s toll-free fraud line increased. Fraud referrals remained relatively flat for FY 2014. DOR has continued to promote the SuspectFraud.com website, and has led stakeholder discussions about new ways to find referrals.

Figure 9: Number of fraud referrals, by month, FY 2014

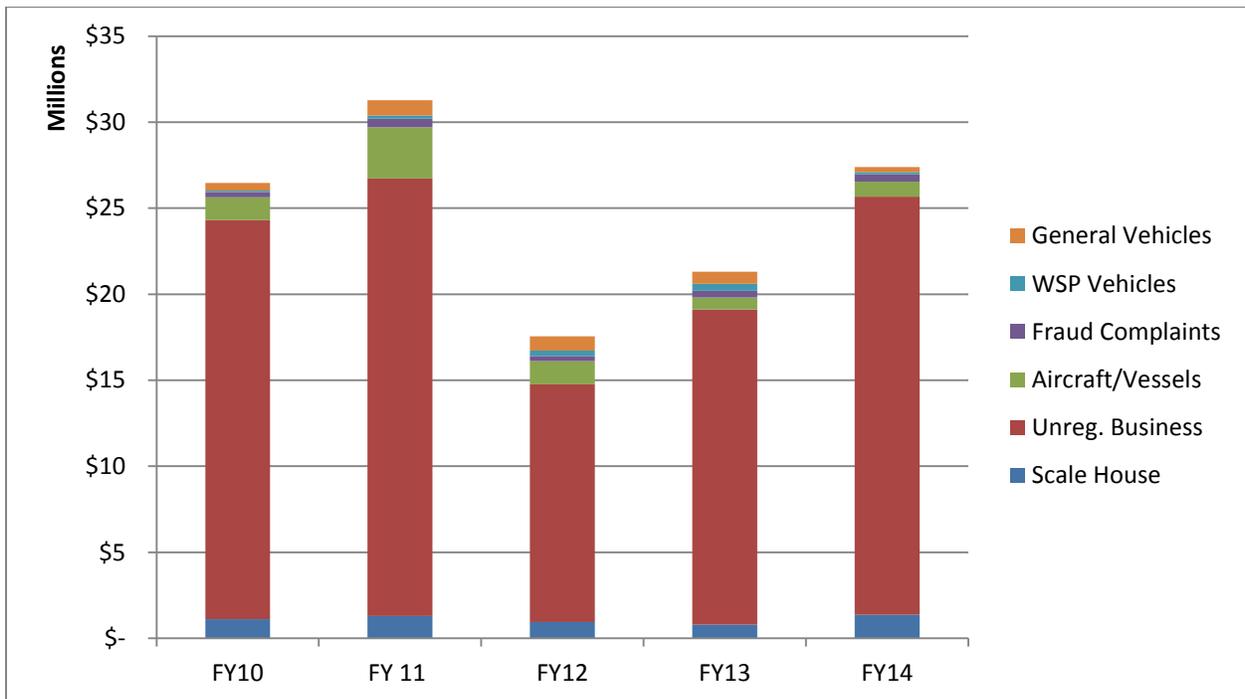


Source: Department of Revenue

If a DOR taxpayer investigation determines there is strong evidence the taxpayer is breaking reporting and/or tax laws, DOR may refer the account to its Criminal Litigation Unit (CLU). The CLU works with the Attorney General’s Office to prosecute a limited number of cases, which may include fraud, evasion or other illegal activity.

Referrals for cases from the underground economy come from investigations, shared information with other agencies and fraud complaints. Unregistered businesses continue to be the largest portion of the tax-discovery cases.

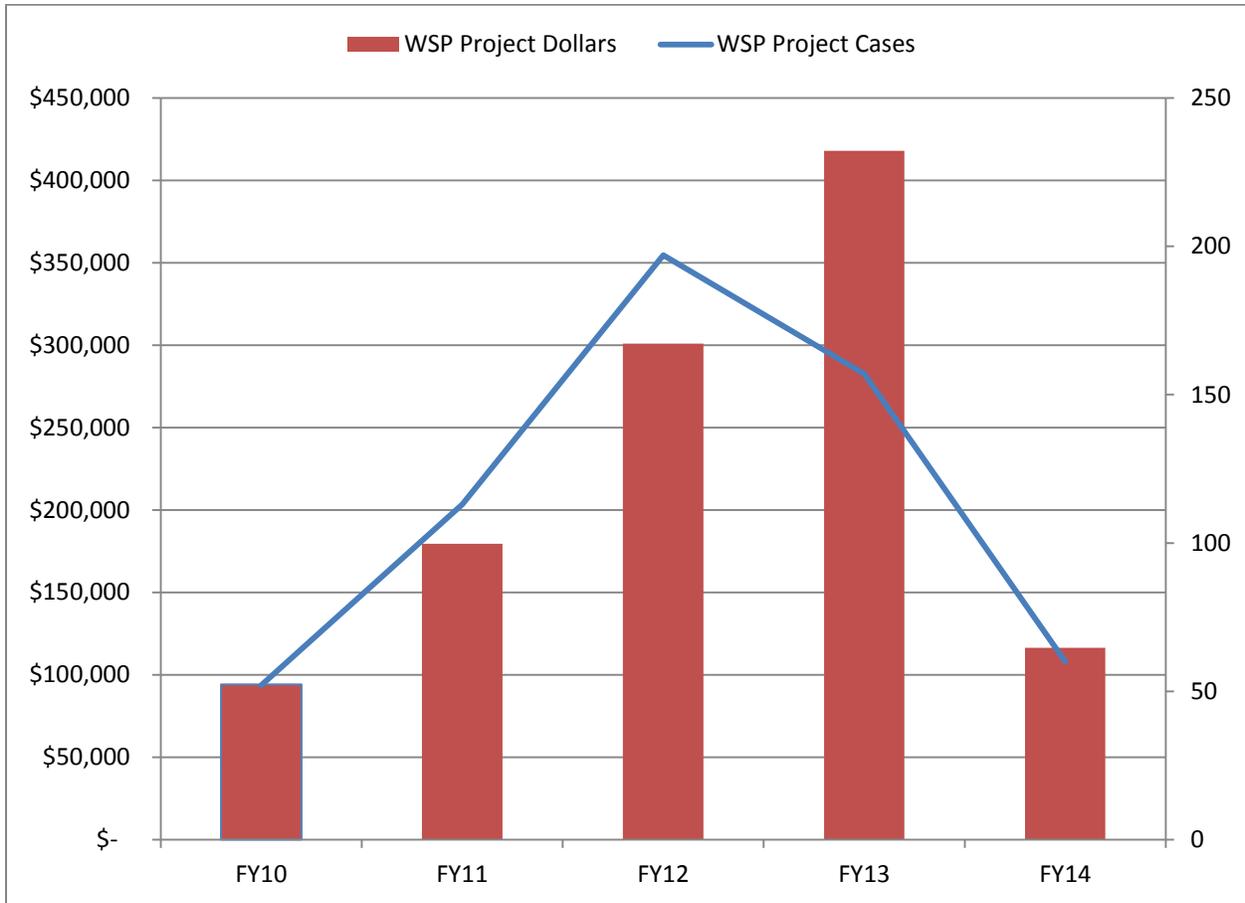
Figure 10: Tax-discovery case type



Source: Department of Revenue

As resources are dedicated to projects, the projects get more referrals and collect more dollars. In FY 2013, DOR dedicated an agent to working on referrals from the Washington State Patrol. This resulted in an increase in the cases and dollars collected by the project. In FY 2014, this position experienced frequent turnover, resulting in a drop in the dollars collected, as new agents had to be trained.

Figure 11: Tax-discovery Washington State Patrol case project vehicle fraud referrals



Source: Department of Revenue

ESD HIGHLIGHTS

During the past year, ESD continued to identify employers who failed to report or underreported employees for unemployment insurance. In FY 2014, the department dedicated seven full-time employees in five audit regions for this purpose.

Underground economy compared to other audits with misclassified employees

From July 1, 2013, through June 30, 2014, underground-economy audits were consistently more productive in locating misclassified employees. For this period, an underground-economy audit uncovered an average of 15.3 employees per audit compared to 1.6 employees per all other audits where previously unreported employees were found.

Figure 12: Underground-economy audits

Quarter	Number of audits with employees found	Number of misclassified employees	Employees per audit
3/13	39	556	14.3
4/13	29	178	5.7
1/14	31	283	8.8
2/14	35	1,113	30.1
Total	134	2,130	15.3

Source: Employment Security Department

Figure 13: All other audits

Quarter	Number of audits with employees found	Number of misclassified employees	Employees per audit
3/13	352	1,015	1.6
4/13	264	927	1.9
1/14	377	1,134	1.6
2/14	423	1,230	1.5
Total	1416	4,306	1.6

Source: Employment Security Department

Electronic reporting

ESD encourages employers to file their quarterly unemployment tax reports electronically. There are currently two options for employers to file quarterly reports electronically, with each option tailored to specific business needs. In FY 2014, 92 percent of employers filed their tax reports electronically.

Improved audit selection

ESD continued to review historical audit data to identify industries of interest. Continuing to share audit information with DOR and L&I also has led to productive audits. Figure 14 shows referrals between agencies made by auditors.

Figure 14: Audit leads from DOR and L&I

Department	Audit leads from auditors	Audit leads from file transfers
Labor & Industries	32	3,612
Department of Revenue	57	7,584

Source: Employment Security Department

Unemployment tax dollars assessed due to DOR and L&I leads in FY 2014 totaled \$219,959.
Unemployment tax dollars collected due to DOR and L&I leads in FY 2014 totaled \$118,890.

Agency results from auditing unregistered businesses

In FY 2014, DOR, ESD and L&I found and audited nearly 1,900 unregistered or previously registered businesses. In these cases, the agencies “involuntarily register” the businesses as part of the auditing process. The three agencies assessed over \$27 million in taxes, penalties and interest on the previously unregistered firms. Due to differences in the regulatory authority of the three agencies, they each tend to audit different types of businesses:

- DOR audits all businesses in the state, regardless of whether they have workers. DOR also has a much stronger role in auditing out-of-state businesses that do business in Washington.
- Both L&I and ESD audit only employers with workers covered by workers’ compensation and unemployment insurance. L&I tends to focus on industries with a high injury rate and has specific additional regulatory authority over the construction industry. ESD tends to focus on industries with higher unemployment rates.

Figure 15: Department of Labor & Industries
FY 2014 audit assessments on unregistered or previously registered accounts

*Assessments include tax, penalties and interest.

Industry sector description	Accounts assessed	Dollars assessed
Construction	675	\$7,271,037
Manufacturing	10	\$ 38,213
Other	25	\$ 534,193
Retail	41	\$ 108,439
Service	213	\$ 2,295,208
Wholesale trade	13	\$ 53,133
Total	977	\$ 10,300,222

Source: Department of Labor & Industries

Figure 16: Department of Revenue
FY 2014 assessments on unregistered accounts

Industry sector description	Accounts assessed	Dollars assessed
Construction	29	\$ 239,907
Manufacturing	78	\$ 1,293,884
Other	89	\$ 125,896
Retail	117	\$ 1,542,545
Service	235	\$ 8,115,619
Wholesale	244	\$ 5,103,449
Total	792	\$ 16,421,300

*Assessments include tax, penalties and interest.

Source: Department of Revenue

**Figure 17: Employment Security Department
FY 2014 assessments on unregistered accounts**

Industry sector description	Accounts assessed	Dollars assessed
Construction	19	\$ 68,458
Manufacturing	2	\$ 5,536
Other	20	\$ 250,083
Retail	7	\$ 9,384
Service	88	\$ 258,217
Wholesale	3	\$ 14,049
Total	139	\$ 605,729

Source: Employment Security Department

Overall, the most productive audits during FY 2014 were for “other” industries. They averaged \$12,504 in dollars assessed per audit, an increase for that industry sector from FY 2013. In FY 2013, 61 more audits were completed, but they averaged \$5,213 in dollars assessed per audit. Overall, 66 fewer audits were completed in FY 2014, mostly due to staffing reductions. However, the average dollars assessed per audit increased from \$4,053 in FY 2013 to \$4,358 in FY 2014.

Conclusion

CONTINUING THE PARTNERSHIP

The multi-agency effort to dismantle the underground economy will continue to be a critical mission for DOR, L&I and ESD. The agencies are strengthening their partnership by sharing information and meeting on a regular basis. They engage with stakeholders to identify problems and create new tools for achieving compliance. Enforcing state laws and providing education and assistance will help level the playing field for employers and workers who already do their best to follow the rules.