

# Underground Economy Benchmark Report 2012 Report to the Legislature

As required by RCW 18.27.800

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**Joint Report of the  
Washington State Department of Labor & Industries  
Washington State Department of Revenue  
and the  
Washington State Employment Security Department**

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## **Introduction and Background**

The report is intended to provide the Legislature with information on the effectiveness of state efforts to combat the Underground Economy by the Department of Labor & Industries (L&I), the Department of Revenue (DOR), and the Employment Security Department (ESD). Particular emphasis is placed on data sharing between the agencies and other areas where the agencies have partnered to uncover and take action on tax misreporting or fraud. Even though the Joint Legislative Task Force on the Underground Economy ended in 2009, the agencies remain committed to working together and sharing information in order to prevent fraud and reduce the impacts of the Underground Economy.

In 2009, the Legislature adopted Substitute House Bill 1555 relating to the recommendations of the Joint Legislative Task Force on the Underground Economy that, among other things, requires L&I, DOR, and ESD to coordinate and report on the effectiveness of efforts to address the Underground Economy to the appropriate committees of the legislature by December first of each year.

## **Report Highlights for Fiscal Year 2012 (July 2011 – June 2012)**

- n DOR, ESD and L&I uncovered a combined 1,802 unregistered businesses that were assessed nearly \$29 million in unpaid taxes, premiums, penalties and interest.
- n DOR, ESD and L&I exchanged 33,245 tips and leads through electronic data matches.
- n L&I collected \$163.8 million from delinquent employer premiums.
- n ESD found 12,607 unreported or misclassified workers through audits.
- n L&I issued 2,426 infractions to unregistered contractors.
- n DOR, ESD, and L&I made alternatives for late payments accessible and provided information on the availability of interest and penalty waivers.
- n L&I provided education and training to over 1,200 construction contractors through outreach events.

Number of tips and leads shared between agencies:

Cross-agency Referrals								
Referral from...to	FY 2009		FY 2010 <sup>1</sup>		FY 2011		FY 2012	
	Via Interagency Referral Form	Via Electronic Data File Transfers	Via Interagency Referral Form	Via Electronic Data File Transfers	Via Interagency Referral Form	Via Electronic Data File Transfers	Via Interagency Referral Form	Via Electronic Data File Transfers
DOR to L&I	1	9,396	3	38,087	3	9,446	20	12,861
DOR to ESD	11	2,109	21	33,659	36	9,446	30	9,646
L&I to DOR	49	5,430	29	5,594	10	5,097	18	5,594
L&I to ESD	89	4,899	23	18,192	23	2,848	4	1,791
ESD to L&I	8	3,633	10	2,829	7	2,177	33	1,390
ESD to DOR	26	0	5	2,651	9	1,603	12	1,963
<b>Total</b>	<b>184</b>	<b>25,467</b>	<b>91</b>	<b>101,103</b>	<b>88</b>	<b>30,617</b>	<b>117</b>	<b>33,245</b>

Source: DOR

Note: We currently measure tips received from auditors at other agencies and tips sent to other agencies. State agencies cannot share IRS data for this and similar purposes.

<sup>1</sup> File transfer sharing totals in 2010 were an anomaly due to a 2009 interruption of data sharing by DOR: DOR had previously shared audits with ESD until sometime in 2009 when there was a lapse. Once a new sharing agreement was in place in 2010, DOR started sharing audits with ESD again. DOR did a “bulk catch with L&I” in FY 10 as L&I was sending audits to DOR, but DOR was not sharing audits with L&I.

# Department of Labor & Industries: Highlights

**Collections** – Collected \$163.8 million in delinquent employer premiums.

**Improved audit selection** – 76% of employers referred for audit owed premiums, compared to less than 50 percent in FY 2004 when the Fraud Prevention and Compliance program began.

**Prosecutions** – Three employers were convicted, resulting in eight Class-C felonies for false reporting, two 1st degree theft, and two gross misdemeanors (1 for false reporting, 1 for engaging in business without certificate of coverage). One employer was court-ordered to pay past due restitution of \$50,000. Total restitution was ordered in the amount of \$105,053.

**Construction Compliance** – 2,426 infractions issued to unregistered contractors, 41% more than in FY 2011.

## Contractor Registration Enforcement Efforts

L&I protects consumers through the registration of construction contractors, which provides a minimum level of bonding and insurance coverage for homeowners, companies supplying labor, materials or equipment, from fraudulent or incompetent construction contractors. Since 2004, all contractors must have a valid Unified Business Identifier Number (UBI) in order to register. During Fiscal Year 2012, the department registered or reregistered 51,492 contractors.

**Year-end Contractor Registrations**

<b>Fiscal Year</b>	<b>With UBI</b>
2004	51,938
2005	54,172
2006	56,181
2007	59,323
2008	60,769
2009	56,685
2010	53,993
2011	52,645
<b>2012</b>	<b>51,492</b>

L&I will deny registration or suspend the contractor’s registration if they do not comply with the contractor registration laws and rules. During Fiscal Year 2012, contractors were suspended for the following:

- Unsatisfied Judgments : 640
- Cancelled insurance: 19,028
- Cancelled bond: 8,738
- Bond impaired: 51
- Outstanding contractor registration infractions: 15

### **Contractor Penalties**

L&I is committed to improving consumer protection and leveling the playing field for legitimate contractors by informing and educating consumers, providing timely and customer focused services such as Internet registration, and actively enforcing the law. Last year, the program issued 2,589 infractions to unregistered contractors. The Contractor Registration Program also has the authority to penalize individuals up to \$10,000 for submitting false information on the application to become a registered contractor. The program did not issue infractions to contractors for falsifying information on an application.

L&I has been tracking companies who violate registration laws, misrepresenting payroll or employee hours, business without L&I certificate of coverage, or second violation of contractor registration and can prohibit them from bidding on public works contracts for one year due to specific violations.

During Fiscal Year 2012, the program issued 548 strikes and debarred 51 companies from bidding on public works contracts. A company is debarred from participating in public works projects for one to two years after receiving two strikes for the same reason or a combination of one contractor registration and one industrial insurance violation. Several contractors were debarred for violations of contractor registration laws and failure to obtain a certificate of coverage for Industrial Insurance as well as for failure to abide by prevailing wage requirements.

### **Reasons for issuing a Prevailing Wage Strike or Debarment**

Reason	Number of Strikes	Number of Debarments
Contractor Registration Violation	310	10
Industrial Insurance Violation	225	6
Contractor Registration <u>and</u> Industrial Insurance Violation	N/A	27
Prevailing Wage Violation: Failure to file wage report / false filing	10	6
Prevailing Wage Violation: Failure to pay prevailing wage	3	2
<b>Total</b>	<b>548</b>	<b>51</b>

## **FAIR TEAM Enforcement**

Increasing the presence of compliance inspectors in the field has a direct impact on the Underground Economy. In 2006, L&I created the Fraud/Audit/Infraction/Revenue (FAIR) Team to identify fraudulent employers and stop illegal contractors. The six-member FAIR Team worked in the field as the literal “boots on the ground”. They conducted job-site inspections, including on nights and weekends, to put pressure on the Underground Economy. In 2011, L&I met with business and labor representatives about improving compliance. Based on stakeholder input, we reorganized our inspector workforce. Stakeholders were concerned that inspectors did not have a large presence in the field. We responded by eliminating inspectors’ other responsibilities. There are now 22 inspectors and 3 supervisors in three regional compliance teams that are based on the FAIR Team model.

Inspectors watch for all types of violations when on job sites. They enforce plumber and electrical certification rules and check contractor registration. In the field inspectors are able to spot employers who owe significant debt to L&I. They confirm worker counts for comparison to reported numbers and make audit referrals. Inspectors also make referrals for potential violations of workers’ compensation, prevailing wage and Department of Revenue rules.

In 2012, there were more jobsite visits and a greater number of contractors checked on site compared to the previous year. In turn, this year there were a greater number of infractions issued. These efforts have made an impact on behavior in the Underground Economy. Unregistered contractors who are cited can receive a reduced penalty if they voluntarily become registered with a bond and insurance within ten days. The number of unregistered contractors who took that option grew by 19% to 262. By the fall of 2011, we heard stories from contractors receiving a compliance inspection. Word is out. Our compliance inspectors are in the field and on the hunt for unregistered contractors.

## **Results:**

	<b>FY 2009</b>	<b>FY 2010</b>	<b>FY 2011</b>	<b>FY 2012</b>
Infractions issued to unregistered contractors*	200	246	241	1,646
Contractors referred to the collections program	195	300	310	Unavailable
Contractors referred to the audit program	436	696	546	1,303

*\*Infractions specific to unregistered contractors.*

Of Note: Prior years were based on FAIR team of 6 FTE’s. Reorganization has increased this to 23 FTE’s.

## Construction Contractor Education and Outreach

The construction industry is where activity in the Underground Economy activity is most visible. Contractors in the Underground Economy are typically either unregistered or underreporting their workers' comp responsibilities and avoid paying their fair share of taxes and premiums. Unregistered contractors present a risk to consumers and gain an unfair advantage over competing businesses playing by the rules. L&I makes it easy for contractors to register with step-by-step instructions and explanations of laws and rules online.

We partner with the building industry to provide training events such as: Contractor Training Days, "Employer's Introduction to L&I" workshops and specialized training events. This year we provided eight Contractor Training Days around the state with over 1,200 contractors attending.

<b>Year</b>	<b>Contractor Training Events</b>	<b>Average Contractor Attendance per event</b>	<b>Estimated Contractors Trained</b>
2008	8	165	Over 1,320
2009	10	130	Over 1,300
2010	8	142	Over 1,100
2011	9	125	Over 1,100
2012	8	130	Over 1,200

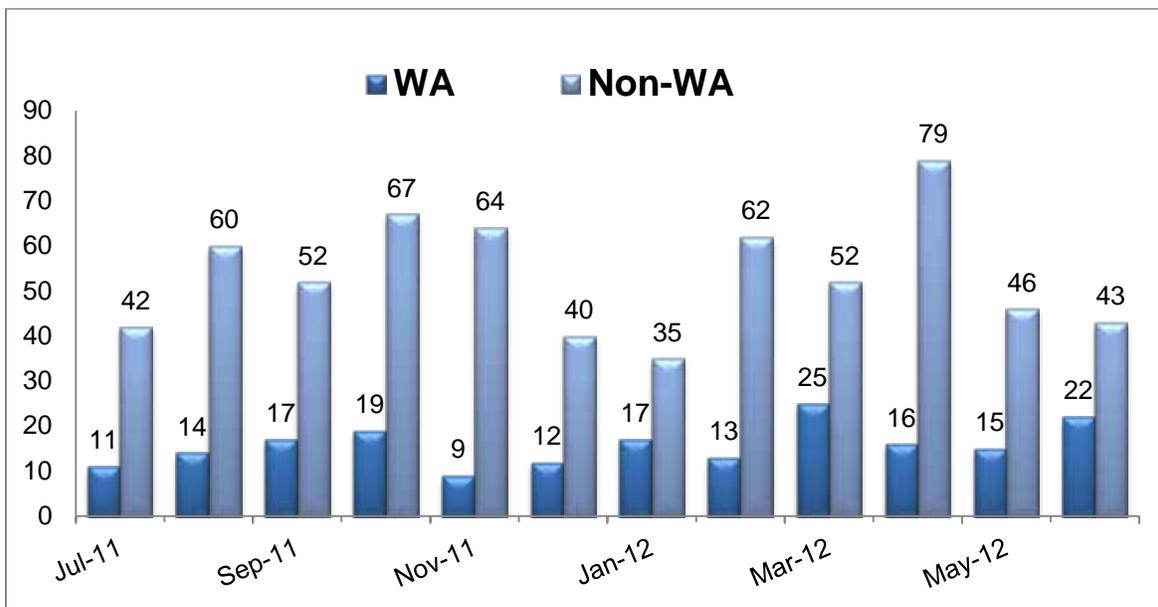
## Department of Revenue: Highlights

The Department of Revenue'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 2012, DOR registered 832 non-compliant businesses and assessed \$17.8 million against them. This included:

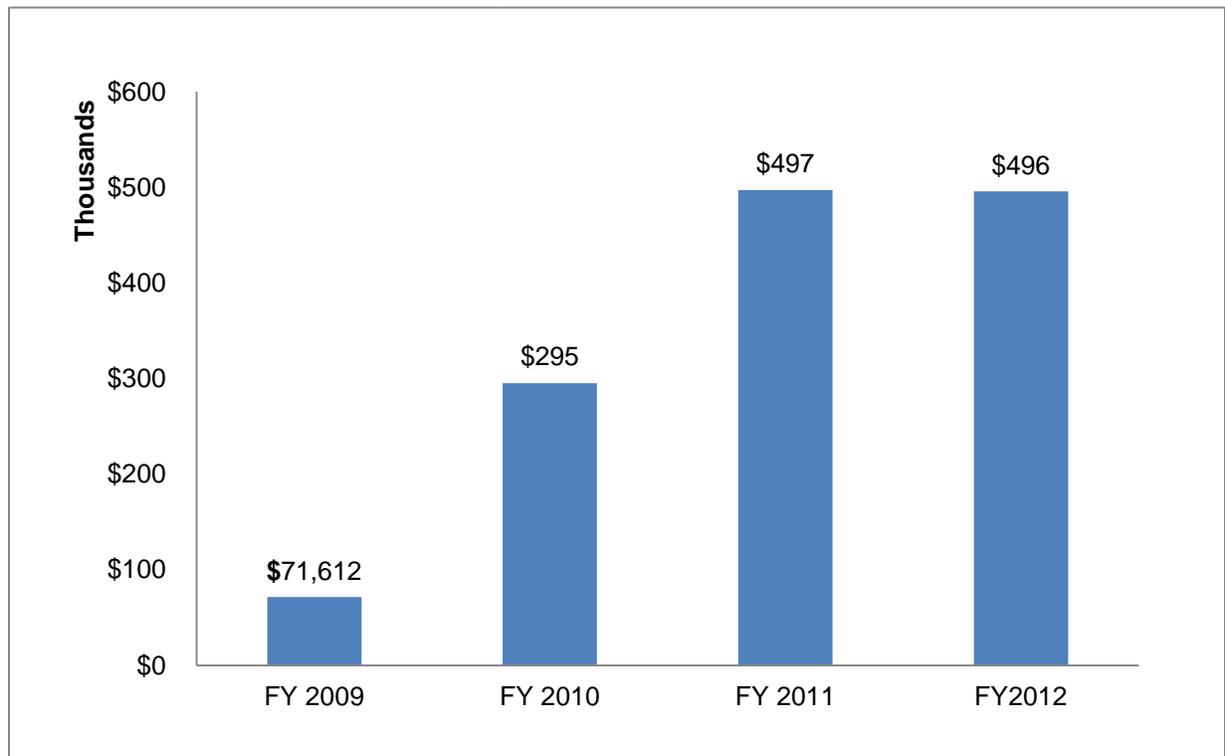
- 190 IN state businesses being assessed \$2.5 million
- 642 OUT of state businesses being assessed \$15.3 million

### Number of Businesses Registered Through Tax Discovery



In addition to unregistered businesses, fraud cases are referred and investigated by both divisions. 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.

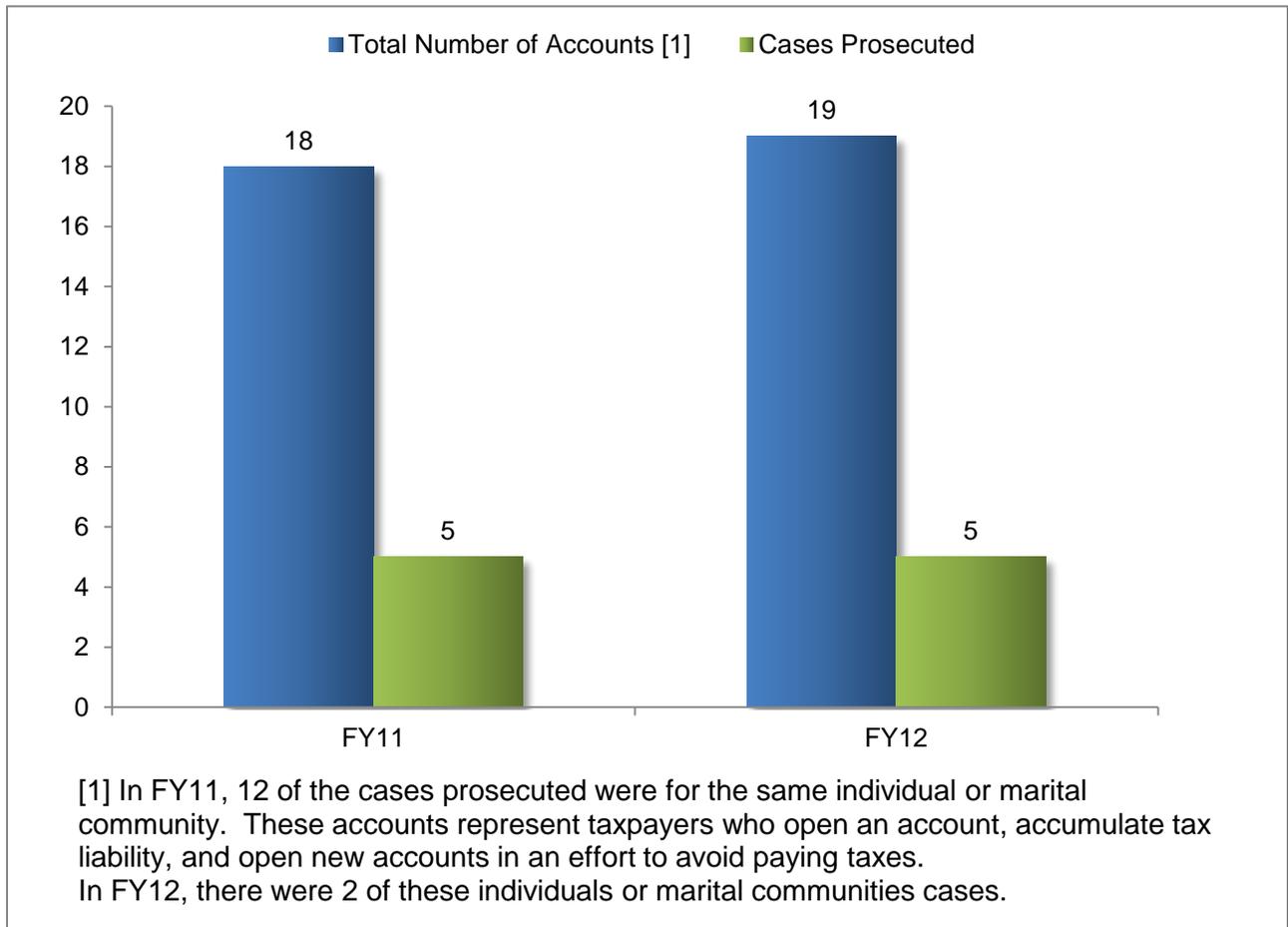
## Fraud Referral Total Dollars Collected (Compliance Division)



### Criminal Prosecutions

If during an investigation of a business it is determined that there is strong evidence that they are engaging in criminal activities, the account may be referred to the Department's Criminal Litigation Unit (CLU). The CLU works with the Attorneys General Office in prosecuting a limited number of cases with respect to criminal activities related to reporting and paying taxes. These cases may include fraud, evasion, or other illegal activity that may pervade the underground economy.

## Number of Accounts Referred to CLU



In Fiscal Year 2012 DOR referred 19 cases to the AAG:

- n 5 cases were successfully prosecuted,
- n 1 had charges filed,
- n 13 were in various stages of pre-filing/investigation/interview.

Referrals for cases from the Underground Economy come from investigation, shared information with other agencies, as well as fraud complaints. Unregistered businesses continue to be the largest portion of the tax discovery cases.

Underground Economy cases come from many different areas. They include: DOR investigations, shared information with other agencies, fraud complaints. Unregistered businesses continue to be the largest portion of the tax discovery cases tackling the Underground Economy.

## Tax Discovery Case Type



## Employment Security Department: Highlights

During the past year, the Employment Security Department continued to identify employers who failed to report or underreported employees for Unemployment Insurance. In FY 2012, the department dedicated one full time employee in each of ten local District Tax Offices to this purpose.

### Underground Economy vs. Other Audits with Misclassified Employees

From July 1, 2011 to June 30, 2012 we can see that Underground Economy audits are consistently more productive in locating Misclassified Employees. For this period an Underground Economy Audit yields an average of 17.3 employees per audit vs. 4.39 employees per all other audits where employees were found.

<b>Underground Economy Audits</b>			
Qtr	Number of Audits with Employees Found	Number of Misclassified Employees	Employees per Audit
3/11	84	938	11
4/11	65	810	12
1/12	66	872	13
2/12	100	797	8
<b>Total</b>	<b>315</b>	<b>3,417</b>	<b>11</b>

<b>All Other Audits</b>			
Qtr	Number of Audits with Employees Found	Number of Misclassified Employees	Employees per Audit
3/11	368	1,377	4
4/11	308	1,404	5
1/12	299	1,687	6
2/12	303	1,386	5
<b>Total</b>	<b>1,278</b>	<b>5,854</b>	<b>5</b>

Employment Security Division also enjoys greater average returns in unpaid taxes found and unreported wages identified through their Underground Economy audits.

### **Electronic Reporting**

ESD has three options for reporting quarterly reports electronically, each tailored to specific business needs. In FY 2011, the department initiated a campaign to increase the number of electronic filers from 80 percent at the end of FY 2010 to 88 percent by the end of FY 2011 which the goal had met at 88.29%. In the second quarter of 2012, we found that 90.44 percent of employers filing electronically.

### **Improved Audit Selection**

ESD continued to review historical audit data to identify industries of interest. Continued sharing of audit information with DOR and L&I have also lead to productive audits as well.

### **Audit Leads from DOR and L&I**

	<b>Audit Leads from Auditors</b>	<b>Audit Leads from File Transfers</b>
Labor & Industries	33	1,791
Department of Revenue	12	9,646

**Dollars Assessed due to DOR and L&I Leads FY 2012: \$427,842**

**Dollars Collected due to DOR & L&I Leads FY 2012: \$69,561**

## Agency Results from Auditing Unregistered Businesses

In FY 2012, DOR, ESD and L&I found and audited a total of 1,802 unregistered or previously registered businesses that were involuntarily reregistered. The three agencies assessed a total of \$28,925,411 in taxes, penalties, and interest on these previously unregistered firms. Because of differences in the regulatory authority of the three agencies, they each naturally 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 are limited to auditing only employers with covered workers. 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.

Industry sector description was determined by North American Industry Classification System (NAICS) codes as follows:

NAICS Sector Code	NAICS Sector Description
23	CONSTRUCTION
31,32,33	MANUFACTURING
0,11,21,22,48,49,53,55,62,92,99	OTHER
44,45,51,71,72	RETAIL
52,54,56,61,81	SERVICE
42	WHOLESALE

## *Labor & Industries*

### **FY2012 Audit Assessments on Unregistered Accounts or Previously Registered Accounts that were Involuntarily Reregistered Totals by NAICS Sector Code**

<b>Industry Sector Description</b>	<b>Accounts Assessed</b>	<b>Dollars Assessed</b>
Construction	360	\$ 4,633,617
Manufacturing	9	\$ 105,900
Other	117	\$ 3,491,537
Retail	105	\$ 512,770
Service	182	\$ 1,292,629
Wholesale Trade	22	\$ 89,088
<b>TOTAL</b>	<b>795</b>	<b>\$ 10,125,541</b>

\*Assessments include tax, penalties, and interest.

## *Department of Revenue*

### **FY2012 Assessments on Unregistered Accounts that were Involuntarily Registered Totals by NAICS Sector Code**

<b>Industry Sector Description</b>	<b>Accounts Assessed</b>	<b>Dollars Assessed</b>
CONSTRUCTION	27	\$ 758,016
MANUFACTURING	82	\$ 1,752,884
OTHER	143	\$ 2,663,834
RETAIL	127	\$ 3,794,703
SERVICE	125	\$ 4,007,863
WHOLESALE	296	\$ 4,801,143
<b>Grand Total</b>	<b>800</b>	<b>\$ 17,778,444</b>

\*Assessments include tax, penalties, and interest.

## *Employment Security*

### **FY2012 Assessments on Unregistered Accounts that were Involuntarily Registered Totals by NAICS Sector Code**

<b>Industry Sector Description</b>	<b>Accounts Assessed</b>	<b>Dollars Assessed</b>
CONSTRUCTION	32	\$ 370,471
MANUFACTURING	7	\$ 44,985
OTHER	43	\$ 174,274
RETAIL	38	\$ 101,171
SERVICE	83	\$ 322,577
WHOLESALE	4	\$ 7,948
<b>Grand Total</b>	<b>207</b>	<b>\$ 1,021,426</b>

Overall, the largest increase in the number of unregistered accounts assessed with additional tax, penalties, and interest was the service sector. The construction sector rose from 30 unregistered accounts identified in FY 2011 to 32 in FY 2012 with significant increase in dollars assessed of \$137,072 in FY 2011 to \$370,471 in FY 2012.