



Underground Economy Benchmark Report (RCW 18.27.800)

2020 Annual Report to the Legislature

December 2020

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Executive Summary

Introduction

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 required by law. As a result, they not only fail to pay their fair share of unemployment insurance contributions, taxes and workers' compensation premiums, but they gain an unfair advantage over competitors. Consumers are put at risk because there is no bond or insurance to protect them.

The Department of Labor & Industries, Department of Revenue, and Employment Security Department are pleased to provide this FY 2020 report on underground economy benchmarks, as required by Chapter 18.27.800 RCW. The three agencies share data and collaborate in other areas to uncover and take action against tax misreporting and other forms of fraud in order to protect consumers, workers, and employers who obey the law.

Progress and achievements in Fiscal Year 2020

In Fiscal Year (FY) 2020, the departments of Labor & Industries (L&I), Revenue (DOR) and Employment Security (ESD) continued to share information on contractor registration, taxes, and other electronic data to discover and hold accountable hundreds of players in the underground economy. Efforts focused in general on education, detection, targeted audit selection, prosecution, and debt collection, as well as prevailing wage requirements and activities. Many of these activities decreased in FY 2020 compared with FY 2019 due to the coronavirus and associated restrictions.

July 2019 - June 2020 (FY 2020) activities

Together, L&I, DOR and ESD:

- Uncovered a combined total of nearly 1,500 unregistered businesses that were assessed nearly \$32.7 million in unpaid taxes, premiums, penalties and interest.
- Provided options for making late payments and information on the availability of interest and penalty waivers.

L&I:

- Educated and trained more than 800 construction contractors through five outreach events statewide.
- Educated nearly 18,000 consumers about their rights and how to hire legitimate contractors.
- Issued over 1,300 infractions to unregistered contractors.
- Performed over 700 audits on unregistered accounts for almost \$7 million in assessed premiums, penalties and interest.

- Collected \$197.5 million in delinquent employer premiums. (While most of this was from standard collection activities and not the underground economy, this money helps keep rates low by ensuring all employers pay their fair share.)

DOR:

- Provided online outreach and assistance to consumers through SuspectFraud.com, and led discussions with stakeholders on new and relevant ways to find leads in the underground economy.
- Registered over 680 non-compliant businesses.
- Assessed taxes totaling over \$25 million from over 340 businesses.
- Collected nearly \$6.4 million through its Tax Discovery Program. (This includes *collection* dollars that were *assessed* in prior fiscal years.)
- Recovered over \$31,000 in fraud-related dollars.

ESD:

- Found over 6,700 unreported or misclassified workers through audits.
- Assessed a total of more than \$612,000 on unregistered accounts.

Introduction

The departments of Labor & Industries (L&I), Revenue (DOR) and Employment Security (ESD) share data and collaborate in other areas to uncover and take action on tax misreporting and other forms of fraud that contribute to the underground economy. 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 and may leave workers without protection in the event of injury, illness or lost wages. Consumers are put at risk because there is no bond or insurance to protect them.

This report provides updated information about how L&I, DOR and ESD discovered and held accountable hundreds of players in the underground economy during Fiscal Year (FY) 2020 through shared information on contractor registration and taxes, and other electronic data. The agencies remain committed to working together and sharing information to prevent fraud and reduce the effects of the underground economy.

In previous years, this report showed data shared by DOR, ESD and L&I to aid in investigating violators. This data is not included in the FY 2020 report due to changes in data tracking at ESD and DOR.

The three agencies, along with external stakeholders, are represented on a Construction Underground Economy Advisory Committee to fight the underground economy in the construction industry. The committee's balance between business, labor, government, and consumer interests makes it possible to share information, leads to new ideas and shared perspectives, improves collaboration, and strengthens key connections.

Progress and Achievements in FY 2020

This section describes progress and achievements of each of the three partner agencies (the Department of Labor & Industries (L&I), the Department of Revenue (DOR), and the Employment Security Department (ESD)) in working together to prevent fraud and reduce effects of the underground economy in Washington.

DEPARTMENT OF LABOR & INDUSTRIES HIGHLIGHTS

L&I protects the safety, health and financial security of Washington’s workers and citizens. As part of this responsibility, the department is committed to helping honest workers, providers and businesses through education and outreach, and by cracking down on dishonest ones.

FY 2020 highlights include:

- **Education** – For first-time or lower-level violators, the focus is on education and help with voluntary compliance. Over the past year, L&I continued working across numerous program areas to analyze and refine compliance efforts to increase focus on improving compliance through education. Compliance inspectors provided training to approximately 800 contractors and employers during FY 2020.
- **Detection** – While education is the first step in increasing compliance, repeat violators and egregious “bad actors” get a more comprehensive and sustained focus aimed at stopping the violations. In the area of employer fraud and misreporting, L&I investigators pursued 13 misrepresentation penalties, totaling over \$660,000, for misclassifying or underreporting employees for workers’ compensation insurance. Contractor compliance inspectors issued over 1,300 infractions to unregistered contractors.
- **Audit selection** – The number of employers referred for audits and found to owe premiums remains steady at about 74 percent. L&I keeps this percentage consistently high by screening and refining referrals and focusing resources on those businesses most likely to be found out of compliance in an audit, while limiting the number of audits of businesses in compliance.
- **Prosecutions** – Staff investigated and referred six employer cases to the Attorney General’s Office for possible criminal prosecution. The Attorney General’s Office filed criminal charges on three of these case types in FY 2020.
- **Collections** – Collections staff collected \$197.5 million in delinquent employer premiums for workers’ compensation insurance.

Prevailing wage program – Education about prevailing wage requirements continued to be a focus, as L&I conducted 20 workshops for more than 760 participants around the state. In

enforcing prevailing wage requirements, L&I recorded more than 1900 “strikes¹” and debarred 76 companies from bidding on public works contracts.²

Educating employers and consumers

L&I continues its commitment to making it easy to do business with the department, with a major focus on making contractor registration easy. L&I partners with the building industry to offer training events such as “Employer’s Introduction to L&I” workshops, Contractor Training Days, and other specialized training events. The department also provides step-by-step instructions and explanations of laws and rules online. In FY 2020, over 500 employers attended the “Employer’s Introduction to L&I” workshops, and L&I provided five contractor training days to more than 1,200 contractors statewide.

In addition, L&I educated nearly 18,000 consumers about their rights in dealing with contractors and how to hire legitimate contractors.

Detecting dishonest activity

The most recognizable dishonest activity happens in the construction industry, though it also occurs in other industries.

Contractor registration

Construction contractors in the underground economy are typically either unregistered, or underreport workers’ compensation responsibilities. This allows them to avoid paying their fair share of taxes and premiums. L&I protects consumers by registering construction contractors. Unregistered contractors present a risk to consumers and gain an unfair advantage over competing businesses that play by the rules.

To register, contractors must meet the required level of bonding and insurance coverage. This allows some financial recourse for homeowners and suppliers who encounter problems with fraudulent or incompetent contractors. All contractors must have a valid Unified Business Identifier (UBI) number before applying to L&I and paying a registration fee.

¹ A strike is a notice of a violation of contractor registration, workers’ compensation or prevailing wage requirements

² If an employer does not pay a fine or receives a repeat notice of violation of contractor registration, workers’ compensation or prevailing wage requirements, the employer 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.

Figure 1 shows the number of contractor registrations from 2010-2020. In FY 2020, the number of registrations dropped from the previous year due to the coronavirus and associated restrictions.

Figure 1: Active contractor registrations as of June 30, 2020

Fiscal Year	Contractors with UBI
2010	53,993
2011	52,645
2012	51,492
2013	52,250
2014	52,755
2015	54,529
2016	56,652
2017	58,553
2018	63,300
2019	64,808
2020	63,200

Source: Department of Labor & Industries

Contractor penalties

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 FY 2020, L&I's Construction Compliance Program issued more than 1,300 infractions to unregistered contractors. This program can also penalize individuals up to \$10,000 for submitting false information in an application to become a registered contractor. The program issued seven of these penalties to contractors in FY 2020.

L&I denies or suspends registration of contractors who do not comply with contractor registration laws and rules. A contractor may have their registration suspended for a period of days or weeks multiple times per year. During FY 2020, L&I suspended nearly 24,100 registrations for the following reasons:

- Cancelled insurance: more than 20,000
- Cancelled bond: more than 10,000
- Unsatisfied judgments: nearly 800

- Impaired bond: more than 60
- Outstanding contractor registration infractions: more than 200

Contractors cited for failing to register can receive a reduced penalty if they voluntarily register and get a bond and insurance within 10 days after the citation. In FY 2020, more than 200 unregistered contractors took advantage of that option.

Auditing businesses

L&I audits employers with workers covered by workers’ compensation, focusing on industries with a high injury rate. During FY 2020, L&I performed over 700 audits on unregistered accounts for almost \$7 million in assessed premiums, penalties and interest.

Figure 2 shows L&I’s audit assessment results for previously registered businesses.

**Figure 2: Department of Labor & Industries
FY 2020 audit assessments on unregistered or previously registered accounts**

Industry Sector Description	Accounts Assessed	Dollars Assessed
Construction	388	\$3,965,004
Service	148	\$1,193,875
Other*	63	\$1,075,833
Retail	3	\$7,226
Wholesale trade	3	\$7,415
Manufacturing	2	\$9,504
Total	607	\$6,258,857

*"Other" category includes sectors such as agriculture and forest products.

Source: Department of Labor & Industries

Prosecuting illegal activity

Investigations staff investigated and referred six employer cases to the Attorney General’s Office for possible criminal prosecution. There were three criminal filings of these case types in FY 2020.

Collecting debt resulting from violations

Inspectors in the Contractor Compliance program are L&I's eyes and ears in the field for all types of violations. 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. In FY 2020, inspectors performed 12 surprise compliance sweeps at multiple jobsites to enforce plumbing and electrical laws, check contractor registrations, and identify employers owing significant debt to L&I.

Figure 3 shows the number of violations issued, contractors referred to collections, and contractors referred for auditing from FY 2015 to FY 2020.

Figure 3: Contractor Compliance Program results

Compliance Action	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020
Underground Economy Violations Issued	1,812	2,030	2,103	2,108	2,420	2,092
Contractors Referred to Collections Program	1,707	1,749	1,710	1,763	1,919	1,504
Contractors Referred to Audit Program	1,477	1,508	1,494	1,710	1,775	1,243

Source: L&I Contractor Registration Program

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. Prevailing wage sets a minimum hourly rate of wages, benefits, and overtime that contractors must pay workers on public projects. It ensures workers on public works projects receive a standard rate of wages and benefits for their trade or occupation in their county, and that all contractors competing for public works projects pay their workers at least the minimum established wage rate.

Education and outreach

L&I continues to focus on improving compliance with prevailing wage requirements by educating employers and workers. In FY 2020, the Prevailing Wage program conducted 20 workshops on prevailing wage requirements around the state, reaching more than 760 contractors, businesses, and workers. Workshops were completed in-person until COVID safety measures were enacted. Since March 2020, workshops have been held remotely.

Violations, strikes and debarments

When contractors commit certain violations, the Prevailing Wage program can issue fines and strikes. If a fine is not paid, or additional strikes are received, the company may be debarred. A contractor can be debarred or prohibited from bidding on public works projects for violating one category multiple times, or any combination of the following:

- 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 in which the violation occurred, not in a combination category. For contractor registration and workers' compensation insurance, strikes are cumulative. For example, contractors may receive strikes under the prevailing wage law for violations of contractor registration law (Chapter 18.27 RCW); industrial insurance law (RCW 51.48.020(1) or RCW 51.48.103); or apprenticeship law (Chapter 49.04 RCW). Any combination of two strikes under these laws results in a one-year debarment.

For prevailing wage law, only violations of the same type count toward debarment. Violations of public contracts laws³ stand alone and do not need to be in combination with another violation. Two strikes under RCW 39.12.050 result in a one-year debarment, and two strikes under RCW 39.12.065 result in a two-year debarment.

Figure 4 shows the numbers of strikes and debarments issued in FY 2018, FY 2019 and FY 2020. During FY 2020, the Prevailing Wage program recorded over 1,900 strikes and debarred 76 companies from bidding on public works contracts. The lower number of debarments issued in FY 2019 compared to FY 2018 is due to variations in the kinds of strikes reported each year.

³ RCW 39.12.050, which refers to false filings or failure to file forms such as intents, affidavits, or certified payroll reports; and RCW 39.12.065, which refers to failure to pay prevailing wages.

Figure 4: Prevailing wage strikes and debarments

Reason	FY 2018		FY 2019		FY 2020	
	Number of Strikes	Number of Debarments	Number of Strikes	Number of Debarments	Number of Strikes	Number of Debarments
Contractor Registration Violation	561	25	860	47	584	34
Industrial Insurance Violation	472	5	78	3	1,303	5
Contractor Registration and Industrial Insurance Violation	N/A*	22	N/A*	22	0	30
Prevailing Wage Violation: Failing to File Wage Report/False Filing	22	16	7	5	10	6
Prevailing Wage Violation: Failing to Pay Prevailing Wage	12	5	3	0	5	1
Total	1,067	73	948	77	1,902	76

*Strikes are not reported in combined categories. Instead, they appear in each – or only one – category, depending on the law violated, but they may result in debarment.

Source: Prevailing Wage Program

DEPARTMENT OF REVENUE HIGHLIGHTS

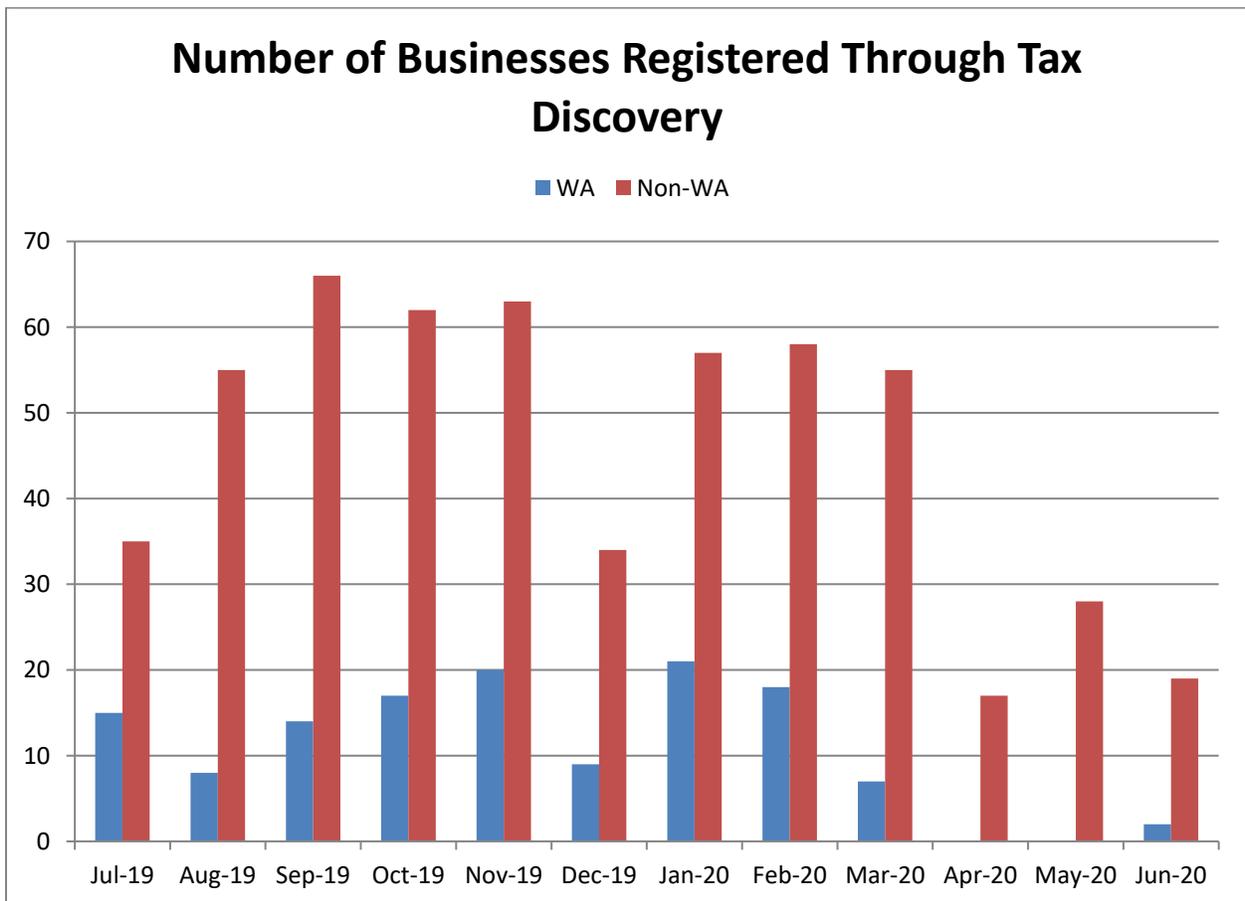
In FY 2020, the Department of Revenue’s (DOR) Compliance and Audit divisions continued to focus on both in-state and out-of-state unregistered businesses in an effort to address the underground economy. Both divisions investigate, assess and register noncompliant businesses.

DOR investigated over 980 noncompliant businesses in FY 2020, 680 of which were registered through Tax Discovery. Of those, more than 120 were found to owe taxes, and over \$14.8 million was assessed against them. This included:

- seven in-state businesses assessed over \$118,000
- 120 out-of-state businesses assessed more than \$14.7 million

Figure 5 shows the in-state and out-of-state businesses found to be unregistered and subsequently registered in FY 2020.

Figure 5: Number of businesses registered through tax discovery



NOTE: In March of FY 2018, the Department of Revenue replaced its aging tax and licensing systems with a new, integrated system. The transition to this system affected the agency’s work and reporting, and some variances have occurred since its implementation.

Source: Department of Revenue

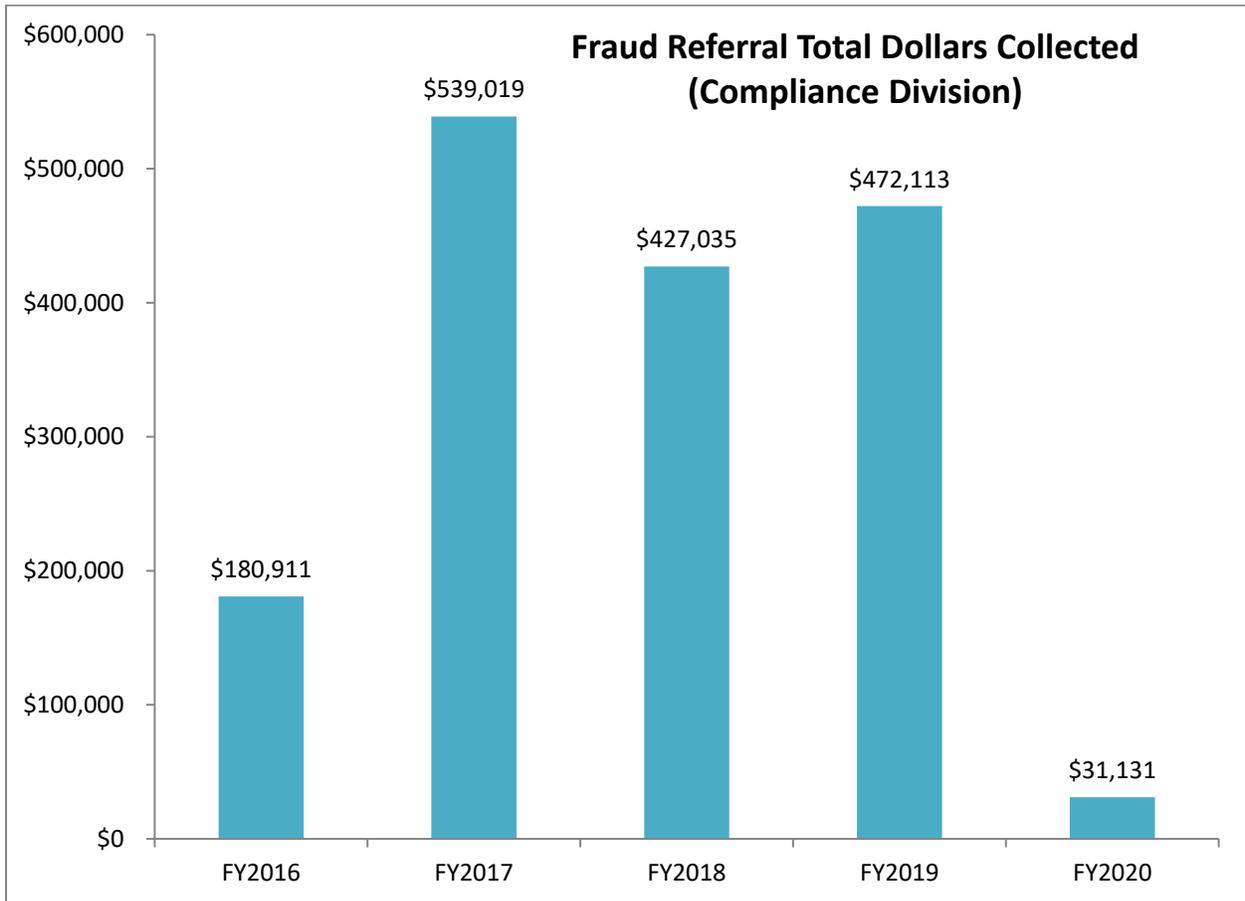
In addition to finding and addressing unregistered businesses, DOR's Compliance and Audit divisions refer and investigate fraud cases. The Compliance Division investigates unlicensed vehicles, vessels, and airplanes. DOR continues to focus on education and enforcement to reduce non-compliance and ensure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

DOR has provided a variety of methods for making fraud referrals, which allow private citizens and other agencies to report cases where they believe fraud is being committed. Figure 6 shows the total dollars collected through fraud referrals from FY 2016 to FY 2020. After a significant increase in FY 2015, the dollars collected dropped off in FY 2016. This coincides with the decision not to run the Suspect Fraud campaign⁴ in FY 2016. Since then, in a coordinated effort between the agencies, efforts are focused toward more targeted marketing to a narrower audience, which includes a survey directed toward the business community through a marketing firm on behalf of the three agencies. This reflects a shift in marketing emphasis from consumers toward the business community.

In FY 2017, the fraud dollars collected increased, with some larger assessments resulting from referrals. In FY 2018, DOR configured and implemented a new system, which resulted in a drop in collections as employees learned the new system. In March of FY 2020, the department halted enforced collections and assessments during the Governor's state of emergency, resulting in a significant drop in the collections on these assessments.

⁴ L&I, DOR, and ESD sponsored the statewide Suspect Fraud campaign to encourage the public to report fraud.

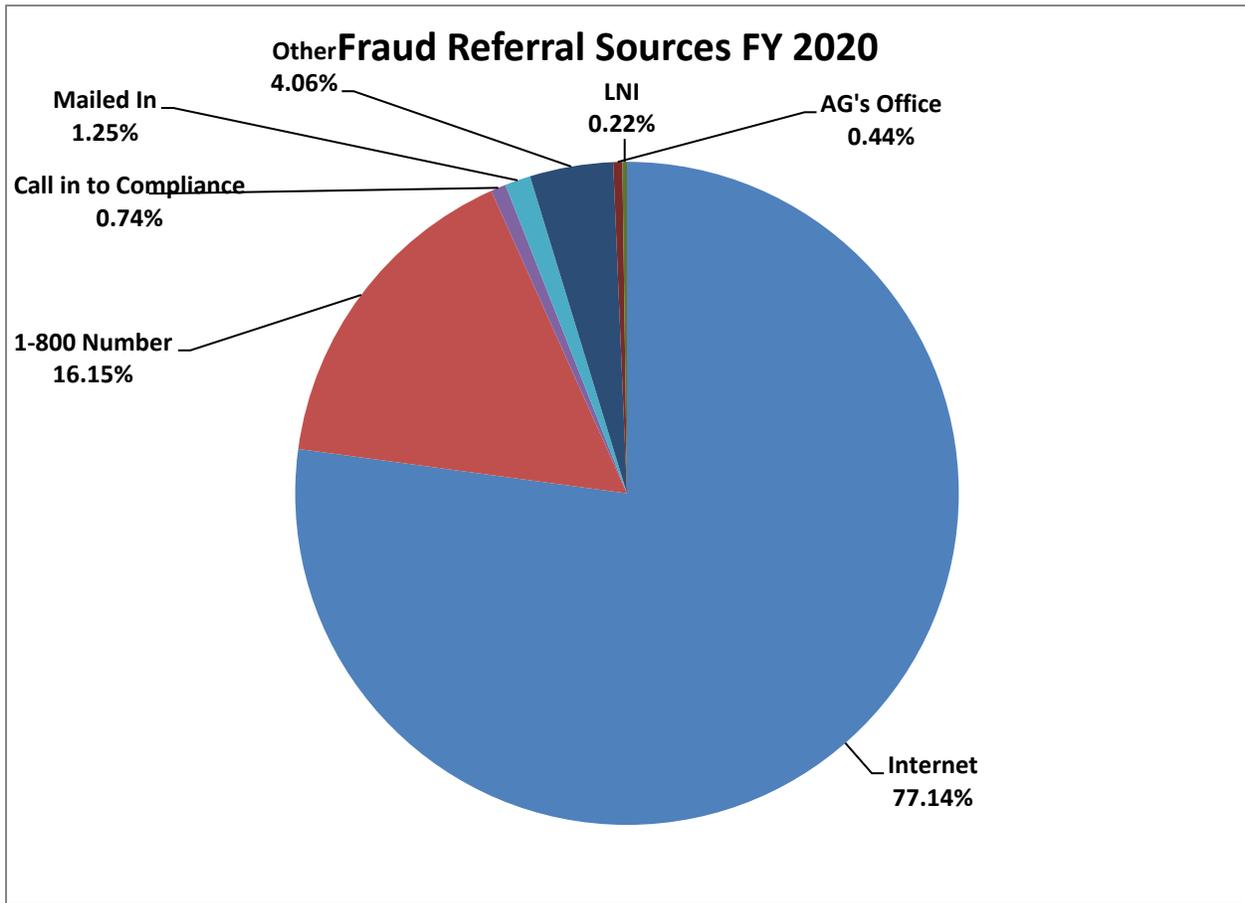
Figure 6: Fraud referral total dollars collected



Source: Department of Revenue

Figure 7 shows the sources of fraud referrals in FY 2020. As shown, the bulk of referrals are received via the internet and the toll-free hotline. In FY 2020, over 77 percent of fraud referrals were made via the website, a slight decrease from FY 2019 with the difference attributed to calls to the toll-free hotline.

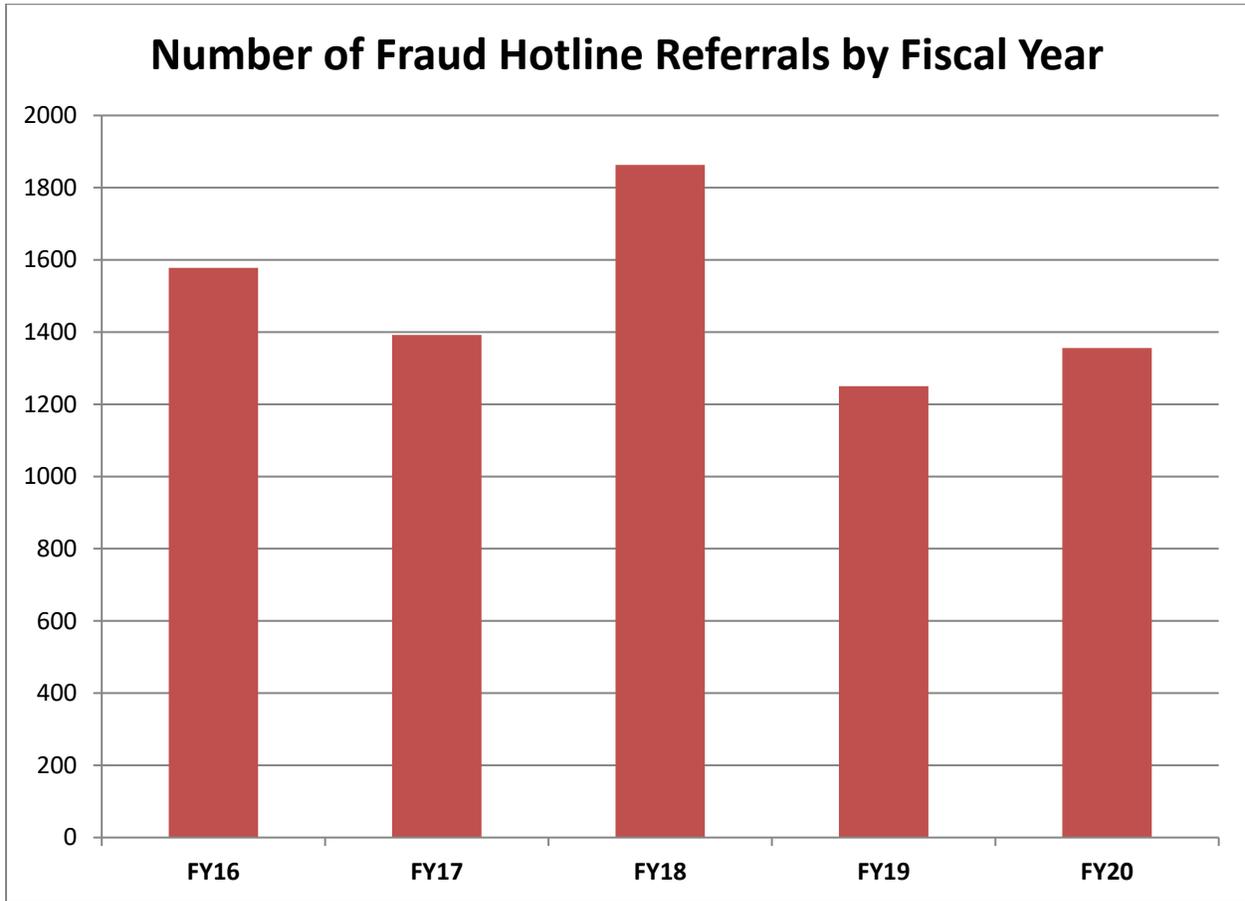
Figure 7: Fraud referral sources, FY 2020



Source: Department of Revenue

Figure 8 shows the number of referrals received through the hotline each fiscal year from FY 2016 to FY 2020. DOR investigates each referral, but it may be found that a business is already registered and reporting, or does not owe taxes.

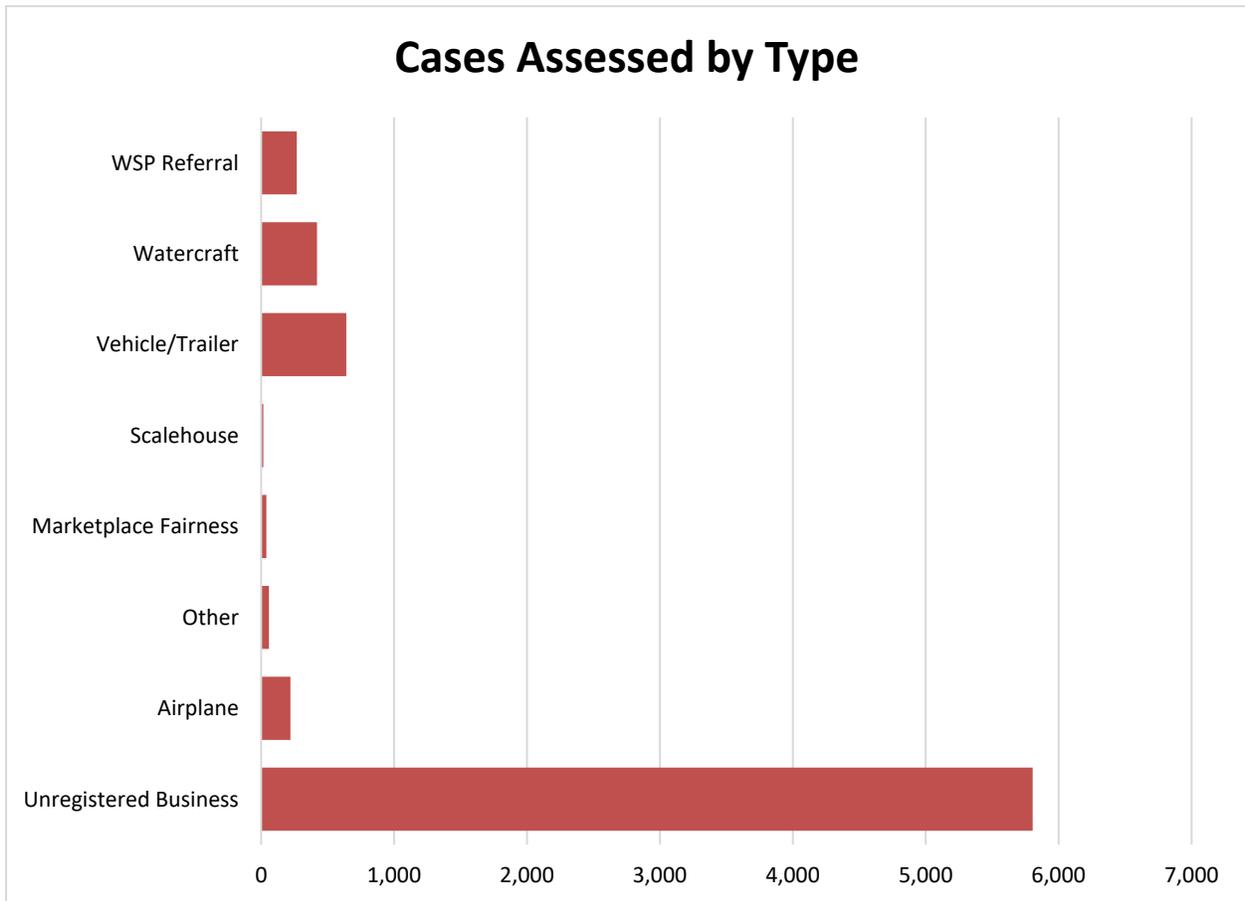
Figure 8: Number of fraud hotline referrals by fiscal year, FY 2020



Source: Department of Revenue

Figure 9 shows the types and number of cases assessed in tax discovery cases. 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 9: Tax discovery case type

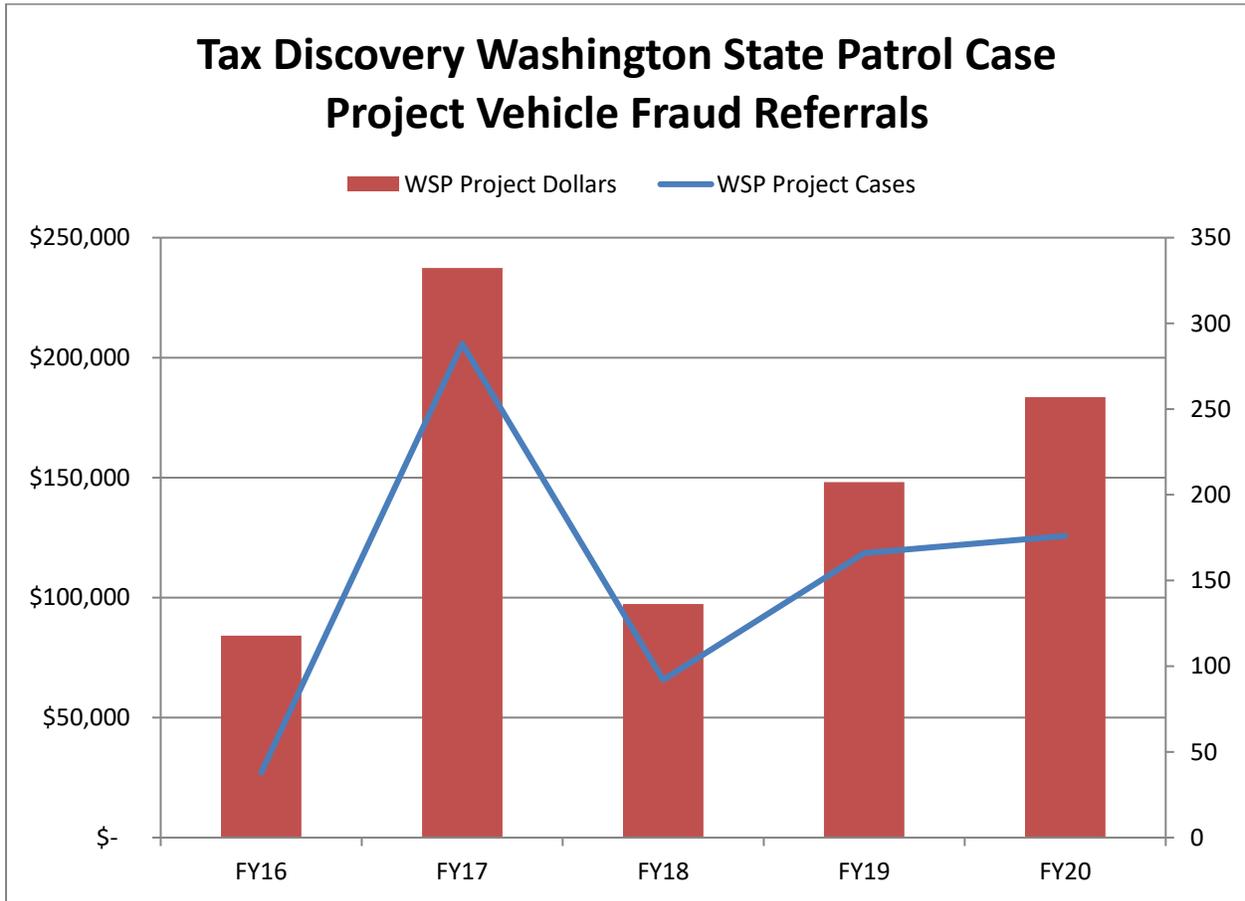


Source: Department of Revenue

As resources are dedicated to projects, the projects get more referrals and collect more dollars.

The Washington State Patrol (WSP) refers cases for investigation related to vehicle fraud, such as registering a vehicle out of state to avoid paying sales or use tax. Figure 10 shows the cases investigated and dollars recovered for the time period from FY 2016 to FY 2020.

Figure 10: Tax discovery Washington State Patrol case project vehicle fraud referrals



Source: Department of Revenue

EMPLOYMENT SECURITY DEPARTMENT HIGHLIGHTS

During the past year, the Employment Security Department (ESD) continued to identify employers who failed to report or underreported employees for unemployment insurance. In FY 2020, the department continued to dedicate seven full-time employees in five audit regions for this purpose.

Underground economy compared to other audits with misclassified employees

From July 1, 2019 through June 30, 2020, underground economy audits were consistently more productive than all other ESD audits in locating misclassified employees. As shown in Figures 11 and 12, in FY 2020, an underground economy audit uncovered an average of 12.7 employees per audit, compared to 2.4 employees per all other audits where previously misclassified employees were found.

Figure 11: Underground economy audits

Quarter	Number of Audits with Misclassified Employees Found**	Number of Misclassified Employees	Employees Per Audit
3/19	89	894	10
4/19	88	838	9.5
1/20	94	932	9.9
2/20	27	1,141	42.3
Total	298	3,805	**12.7

*The number of employees per audit equals the number of misclassified employees divided by the number of audits with misclassified employees found.

**Number of audits may vary depending on ESD staffing levels at any given time.

Source: Employment Security Department

Figure 12: All other audits

Quarter	Number of Audits with Employees Found	Number of Misclassified Employees	Employees Per Audit
3/19	327	618	1.9
4/19	339	1,167	3.4
1/20	374	680	1.8
2/20	194	453	2.3
Total	1,234	2,918	*2.4

*The number of employees per audit equals the number of misclassified employees divided by the number of audits with misclassified employees found.

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 reports electronically, with each option tailored to specific business needs. In FY 2020, over 95 percent of employers filed their tax reports electronically.

Identifying unregistered employers

ESD's underground economy auditors identified 90 unregistered employers during FY 2020. In addition to receiving tips from other state agencies as shown in Figure 13, the auditors use a variety of tools to identify unregistered employers, including:

- A toll-free fraud hotline
- An online fraud reporting tool
- In-house special investigations
- Benefit redetermination units that investigate and resolve issues about benefit claims

Employer education

As in previous years, ESD continues to look for opportunities to educate employers on tax liability issues and tax reporting requirements. One of the educational tools the agency uses is the ESD voluntary audit program, which allows employers to request an audit from ESD to be educated on correct tax reporting procedures. If the audit results in any findings, ESD will waive any penalties associated with the audit.

COMBINED AGENCY HIGHLIGHTS

Representatives of L&I, DOR, and ESD, along with business, labor, government, and consumer representatives, make up the Construction Underground Economy Advisory Committee. This committee provides an efficient way to share information, leads to new ideas and shared perspectives, and improves collaboration between all parties.

The committee met twice in 2020, in May and October, to coordinate efforts and share information.

Results from auditing unregistered businesses

In FY 2020, DOR, ESD, and L&I found and audited nearly 1,500 unregistered or previously registered⁵ businesses. In these cases, the agencies “involuntarily register” the businesses as part of the auditing process. The three agencies assessed nearly \$32.7 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 may audit 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.

⁵ Even if a business were previously registered under a different name, unless it is currently registered with up-to-date information, it is considered unregistered.

Conclusion

CONTINUING THE PARTNERSHIP

During FY 2020, L&I, DOR, and ESD continued to share information on contractor registration and taxes, and other electronic data, to discover and hold accountable hundreds of businesses and individuals not complying with the law. In addition to protecting consumers, workers, and employers through this activity, the agencies continued to assist construction contractors and other business owners in meeting state requirements.

In addition to improving compliance, enforcing state laws, and providing education and assistance, the three agencies will continue to work together and with their stakeholders to provide meaningful information and data, identify problems, and focus future efforts.