



**Joint L&I, ESD, and DOR Presentation
to the
Legislative Taskforce on the Underground Economy
August 1, 2007**

Agency representatives will provide an overview of the barriers and impediments to monitoring the underground economy and collecting taxes in the construction industry. The overview will be followed by presentations from auditors working in the field.

Presenters:

Department of Labor and Industries

Carl Hammersburg, Fraud Prevention and Compliance Manager
Scott Nielsen, Construction Compliance Inspector
Theresa Bunten, L&I Auditor 3

Employment Security Department

Lisa Marsh, Director, Unemployment Insurance Tax Branch, Employment Security
Diana Johnson, Certified Management Accountant, Auditor 4

Department of Revenue

Drew Shirk, Legislative Policy Coordinator
Donald Gutmann, Revenue Analysis Manager, Revenue
Kevin Dickson, Revenue Auditor 3

Major Barriers:

- 1. Lack of clear, consistent, cross-agency definitions of “worker,” “employee,” and “independent contractor” and court decisions which have resulted in differing treatment among agencies. (See detail in “definitions” handout.)**
- 2. The definition of “registered contractor” and the requirements to become a contractor.**
 - A. Limited requirements for becoming a registered contractor
 - Lack of distinction between general vs. specialty contractors in practice (Many people get both designations)
 - No testing or certification process
 - B. SHB 1843 made some changes in 2007 including:
 - Working while unregistered now a gross misdemeanor
 - Subcontracting to an unregistered contractor now a violation
 - Allows suspension of an active registration if an owner, principal, partner or officer has a prior unsatisfied final judgment from a prior entity

3. **The complexity of legally sharing data among agencies under state and federal privacy requirements.**
 - A. Complexity of confidentiality laws, both federal and state
 - Unable to share or discuss data with other agencies when it is received from IRS
 - Unable to re-disclose information once it is received from other state agencies
 - B. Issues surrounding data sharing agreements
 - Frequency of expiration of data sharing agreements
 - Data sharing agreements may be too limited in scope
 - Data sharing agreements must be amended each time additional information is identified as required
 - C. More effective method to utilize technology to identify inconsistencies in businesses' reporting to agencies
4. **Recruitment and retention of investigators and auditors and limited resources to hire staff.**
 - A. Difficult to recruit and retain people with the skills needed to generate leads, investigate leads, and conduct complex audits in the industry
 - Problem for all three agencies
 - B. Sarbanes Oxley Act placed high demand for auditors in private sector
 - C. L&I has a limited number of staff with specialized construction knowledge dedicated specifically to combat the underground economy in the industry
 - Work nights and weekends
 - Typical auditors lack construction estimation skills
 - Do not have staff to check every job site
 - D. Governor has asked agencies to work on issue
5. **The nature of the construction industry – the “layering” of subcontractors which makes identification and enforcement difficult.**
 - A. General contractors and higher tier subs typically do not report the subcontractors working on their jobsites
 - Drywall reporting of subcontractors at L&I increases compliance
 - Prevailing wage looking at requirements for reporting subcontractors
 - B. Treating workers as independent contractors to avoid tax liabilities
 - Obtaining a contractor registration does not make someone “independent”
 - C. Often a general contractor or high level subcontractor does not know which lower level subcontractors are on their jobsites

6. Getting access to important financial records.

- A. Each agency has different legal authority regarding access to business and personal information.
- Corporate vs. individual records and filings complicates our ability to identify proper reporting
- B. Record retention by contractor and subs may be limited
- Contracts, payments, hours and bank records critical
- C. Difficult to enforce summons and subpoena authority
- Identification of records or possessor of information inconsistent or nonexistent
 - Identification of information is labor intensive and time consuming.
 - Limited consequences for non cooperation
- D. Third party notification requirements before using information - *State v. Miles*, Washington Supreme Court No. 78656-9 (filed April 26, 2007) (court currently considering motion for reconsideration)
- Held that state agencies cannot issue subpoena to third party without prior judicial review where the subpoena seeks information considered a “private affair” under the state constitution, even if the agency has statutory authority to do so
 - Most agencies do not currently have authority to seek prior judicial review of subpoenas
 - Examples of third-party sources are banks, building supply stores, in-state representatives of out-of-state businesses, customers, utility companies and other sources of information that can disclose whether a person is conducting business without registering or paying taxes
 - Unclear whether notice to person about whom information is sought is sufficient without judicial review

7. The nature of the unregistered businesses and the cash economy.

- A. People who participate in the underground economy intentionally hide their activities and don't want to get caught
- Business activities run through personal as well as business accounts
 - Individuals may try to shield themselves from personal liability by using an LLC or corporate structure
 - Need to structure an incentive and penalty system for enforcement that leads to greater compliance and encourages all levels of the contracting system to conduct due diligence with their subcontractors
 - Need to find ways to encourage legitimate contractors and the public to report on underground firms
 - DOR, L&I and ESD maintain phone and web based reporting systems
 - L&I maintains public websites that identify registered contractors and that allow tracking of subcontractors to identify when they fall out of

compliance with either contractor registration or workers' compensation reporting

B. Registered with the IRS but not DOR

- In 2004 there was an estimated \$225 million in Washington state excise taxes owed by businesses registered with the IRS but not registered with DOR
- This represents 99,000 unregistered accounts and 3 percent of taxes collected from registered businesses
- Out-of-state businesses accounted for \$155 million of the total \$225 million with sole-proprietors accounting for an additional \$36 million
- Sole proprietors accounted for 45,000 of the total 99,000 with out of state businesses accounting for an additional 25,000
- Of the Washington based businesses service firms represent most of the taxable activity
- This study does not include losses for unemployment or workers' compensation insurance

C. Registered with neither the IRS or DOR

- Preliminary estimates show an additional \$150 million owed by businesses that did not file with either the IRS or DOR
- This represents the tax due from 65,000 businesses and represents 2 percent of the tax collected from registered businesses
- These estimates do not include losses for unemployment or workers' compensation insurance