

**Questions & Answers for the  
Underground Economy Task Force  
November 14, 2007**

The Underground Economy Task Force members asked a number of questions at their last meeting on October 31, 2007. This handout includes the department's response to those questions. The Employment Security Department (ESD's) response to recommendations for consideration is in the separate questionnaire from legislative staff.

**Q1. What is the ratio of Federal Unemployment Tax Act (FUTA) taxes paid to the US Department of Labor (DOL), number of grants received and national ranking?**

- A.** Actual data on FUTA receipts by States do not exist. The U.S. Department of Labor estimates these data using wage and employment data from required federal reports from the states (ES202 report). The receipts are estimated by first estimating calendar year FUTA taxable wages and then multiplying this by the effective tax rate (.06% basic rate and a .02% surtax on a salary base of \$7,000). The data is then converted into the federal fiscal year (October-September) based on quarterly receipt patterns. The following link provides an opportunity to compare the estimated receipts, compared to administrative grants and the federal share of extended benefits from 1981 to 2006:  
<http://www.ows.doleta.gov/unemploy/budget.asp>

For federal fiscal year 2006, it is estimated that Washington employers paid a total of \$157.7 million in FUTA, with \$31.5 M going to the Extended Unemployment Compensation Account (to pay the federal share of extended benefits, when triggered) and \$126.1 M going to the administrative account.

During 2006, Washington received administrative grants totaling \$97.3 M. This is \$28.8 M less (and only 77.2%) of the estimated administrative revenue from employers. Nationally, administrative grants to all the states were only 57.91% of the estimated administrative revenue. The state percentages range from Florida at 31.54% to the Virgin Islands at 206%. In terms of ranking, if the data is sorted by percentage of return from high to low (Virgin Islands being #1), Washington ranks at #13.

The data (in terms of percentage of revenue returned to the states) changes dramatically when extended benefit programs are triggered.

**Q2. If ESD were to receive more funding for enforcement, how would it be allocated?**

- A.** If ESD received additional funding it would be allocated for additional auditor positions. For eight additional auditors the cost would be approximately \$800,000 per year, of which \$64,000 would be one-time costs. This assumes eight FTEs for the Auditor 4 classification (range 50), located in field offices and traveling to work sites. It also assumes associated facility and technology support costs.

**The break-out of costs would be:**

|                   |   |
|-------------------|---|
| Salary (8.75 FTE) | \$462,183 (includes facilities & technology allocation)                     |
| Benefits          | \$140,097   |
| Goods & services  | \$158,007 (includes \$64,000 one-time costs for workstations and computers) |
| Travel            | \$40,375 (includes \$5,000 per auditor per year)                            |
| <b>Total</b>      | <b>\$800,662</b>  |

**Q3. If ESD received more funding, could we hire more auditors?**

- A. Any budgetary decisions have to be made in conjunction with OFM and the Governor’s office. Recruitment is an issue. However, retention is also a serious problem. ESD believes it could recruit additional auditors. Please see the recommendations memo for ESD suggestions for pay increases.

**Q4. Who is paid more, auditors or collectors?**

- A. Tax Specialist 3 = range 47 (\$3074 – 4033).  
 Auditor 4 positions = range 50 (\$3311 – 4342); there are a total of 4 of these positions.  
 Auditor 5 positions = range 52 (\$3479 – 4562); there are a total of 3 of these positions  
 As a practical matter, in most cases, auditors and collectors at ESD are paid the same because their job functions fall under the same employment classification (Tax Specialist). Tax Specialist 3 is the journey class for both audit and collections, although there are a total of 7 Auditor 4 and Auditor 5 positions in use statewide.

**Q5. Should staffers both audit and collect?**

- A. ESD’s employment model allows the same person to serve as both auditor and collector (although not on the same case) with limited exceptions. This differs from the model used by DOR and L&I, which place auditors and collectors in different job classifications. ESD’s District Tax Offices (DTOs) use various employment models for maximum flexibility and to accommodate the preferences of individual Tax Specialists: most Tax Specialists conduct both audit and collection functions, some specialize and do only audits, and some specialize and do only collections. In addition, there are a total of seven Auditor 4 and Auditor 5 positions in use statewide, in which collection functions are limited in scope.

Many Tax Specialists currently prefer the variety of doing both functions, while ESD also is able to accommodate individuals who prefer either audit or collection. Separating the functions will decrease flexibility both for the agency and for the individual Tax Specialists. Requiring separate classification into collectors and auditors would significantly restrict ESD’s ability to use small, localized DTOs because of overspecialization and inability to cover others in a small office.

**Q6. Does the current staff model contribute to audit or turnover?**

- A. There is no evidence that using a single classification series (Tax Specialist) contributes to staff turnover. Exit interviews have not shown that staff left because they did not want to do collections. Maintaining a single classification may reduce turnover because it allows ESD to

accommodate personal preferences in DTOs, whether for the variety of a mixed caseload or for specialization in one function or the other.

Concerns about salary level may contribute to turnover and to difficulties in recruitment, but ESD views these as separate from the issue of a staffing model allowing the same individual to both audit and collect.

**Q7. Can state agencies create a single inter-agency statutory definition of “independent contractor” for ESD, DOR and L&I?**

A. ESD is meeting with Labor, Business, L&I, and DOR to discuss this. ESD’s basic definition is in RCW 50.04.140 and technically defines tests for exceptions to employment. This definition uses both the “ABC” test and, alternatively, the six-part test which is identical to L&I’s in RCW 51.08.195.

**Q8. What is the overall breakdown of penalties by violations in the construction industry?**

A. We do not have penalty data broken out separately for the construction industry, but see next question for all penalties.

**Q9. What are the most violations by penalty type?**

A. See chart

Fiscal Year 2007  
Penalty, interest, and fees - violations and collections

| Numbers of violations                   | FY07 total |
|---|------------|
| Late report                             | 38,620     |
| Late payment                            | 46,931     |
| Claimant accounts with interest applied | 115,594    |
| Employer accounts with interest applied | 46,931     |
| Legal fee                               | 2,550      |
| Wrong format                            | 596        |
| Incomplete report                       | 3,820      |
| Audit cost                              | 1          |
| Payroll fraud                           | 1          |

**Q10. What are the amounts of penalties and interest by penalty type?**

A. See chart

| Dollars collected                       | FY07 total          |
|---|---------------------|
| Late report                             | \$740,864           |
| Late payment                            | \$3,255,874         |
| Claimant accounts with interest applied | \$6,263,059         |
| Employer accounts with interest applied | \$1,555,609         |
| Legal fee                               | \$110,515           |
| Wrong format                            | \$36,681            |
| Incomplete report                       | \$164,221           |
| Audit cost                              | \$5,788             |
| Payroll fraud                           | \$1,104             |
| <b>Total</b>                            | <b>\$12,133,716</b> |

**Q11. What discretionary penalties, such as the penalty for knowing misrepresentation in RCW 50.12.220 (up to 10 times taxes owed) or the criminal penalties in ch. 50.36 RCW, has the department applied, both generally to all employers and specifically to the construction industry?**

A. There are very few instances in recent years in which ESD has applied these penalties. ESD routinely applies late report or late payment penalties and incomplete or incorrect format quarterly report penalties, but rarely has used these discretionary penalties.

- One case currently under appeal to the Office of Administrative Hearings involves a southwest Washington glass shop that allegedly attempted to avoid union-shop requirements by misclassifying hired non-union family members as non-employees. The ESD audit found knowing misrepresentation and imposed the 10x penalty for a total amount of \$55,000, including about \$950 in routine penalties (e.g., late payment and late report penalties), \$700 in interest, and \$48,000 in special penalties.
- Another case in which the misrepresentation penalty (10x) was considered, but ultimately not applied, was an eastern Washington concrete company audited by both L&I and ESD. The ESD audit led to an assessment of \$14,000, including about \$2,000 in routine penalties and \$1,600 in interest. Even though the penalty was not applied, the employer appealed and the case is currently pending before the Office of Administrative Hearings.
- Yet another case in which the 10x penalty was considered, but ultimately not applied, was a South Puget Sound area construction company audited by both L&I and ESD. The ESD audit discovered 16 employees and assessed \$7,500, including about \$1,300 in routine penalties and \$900 in interest. Even though the knowing misrepresentation penalty was not applied, the assessment was still appealed and ultimately settled in June 2007.

- There is at least one other pending case involving a trucking company in which the department is currently considering use of misrepresentation penalties.
- Criminal penalties are also provided in ch. 50.36 RCW, but these have not been invoked in recent years. Cases would have to be referred to prosecutors to apply these penalties.
- One of the reasons why so few cases have assessed penalties is a conflict between RCW 50.12.220, which authorizes penalties up to ten times taxes owed, and WAC 192-310-030(4), which specifies that the penalty is ten times taxes owed. The rule did not allow the department the flexibility provided in the statute. This is in the process of being remedied and the amended WAC paralleling the RCW should take effect Jan. 1, 2008.
- In addition, the application of routine penalties and changes in the liable date because of an audit may lead to application of the highest tax rate for delinquent taxpayers. The routine penalty for late payments under RCW 50.12.220 escalates until it reaches 20% of taxes due in the third month. Because of the effect of routine penalties and changes from an audit, the employer is likely to lose its status as a “qualified employer” under RCW 50.29.010 because it owes taxes as of the Sept. 30 “cut-off date” for calculation of tax rates. The result will be that the employer is penalized with the highest tax rate. For example, if an employer with 10 employees, each of whom earns over \$31,400, currently has a tax rate of 2% and receives a delinquency rate of 6.23%, the effect is to increase unemployment taxes from \$6,280 to \$19,562, an increase of \$13,282.

It is also significant that all three cases in which misrepresentation was considered have been appealed, even though the department chose not to apply the misrepresentation penalty in two of the three. In part this was because of the effect of the audit on tax rates even without a separate discretionary penalty.

**Q12. What percentage of audits is in the construction industry?**

A. See chart below.

**Percentage of audits conducted by year**

| Calendar year     | Construction audits | Total audits | Percentage |
|-------------------|---------------------|--------------|------------|
| 2005              | 573                 | 4,148        | 13.8 %     |
| 2006              | 678                 | 3,990        | 17.0%      |
| 2007 (Jan – Oct.) | 1,004               | 3,543        | 28.3%      |

In July 2006, ESD changed its approach from random audits to targeted audits. In the 18 months of random audits prior to July 2006, the average percentage of construction industry audits was 14.4%. This was simply based on random selection. In the 16 months of targeted audits since then, the construction industry has been among those targeted and the percentage of construction industry audits has risen to 24.9%.

**Q13. Is there geographical information regarding the incidence of violations in the underground economy?**

- A. Yes. The draft Unregistered Business Study Joint Report by the Washington State Departments of Revenue, Labor and Industries, and Employment Security estimates unemployment taxes due from all industries of \$15 million, including \$8 million from Puget Sound, \$4 million from other western Washington, and \$3 million from eastern Washington. The study estimates unemployment taxes due from the construction industry of \$3.4 million statewide, including \$1.7 million from Puget Sound, \$1.0 million from other western Washington, and \$0.7 million from eastern Washington.