



By Stephen G. Revay

The July 1993 issue of the Revay Report featured an article on "**Risk Management in Construction Projects**" by Dr Pierre Menard of UQAM and Regula Brunies of RAL. It described the general methodology of Risk Management as applied to commercial

risks faced by Owners and Contractors. It concluded that the process should be an essential element of strategic project management.

This issue deals with a specific potential risk area faced by Owners, Contractors and members of the construction industry generally - "underground" or unrecorded construction activity. By all accounts, its incidence has increased substantially throughout Canada during the period since the publication of our previous issue.

Much of this growth has been insidious. Many Owners and Contractors may not even be aware of its existence on their projects, or of potential liability.

Moreover all readers face a further dimension of this risk in their common capacity as **householders**.

The underground economy has attracted considerable attention from economists, statisticians and tax officials. A current study sponsored by Human Resources Development Canada focuses on the labour market implications of underground construction employment, especially if it increases in the years ahead.

KPMG is the prime consultant and its program team includes two members from RAL - Don Chutter of Ottawa and Carol Wagner of Montreal. Don is serving as Project Manager and is the author of the following article.

THE, "UNDERGROUND" CONSTRUCTION ECONOMY A NEW FACTOR IN RISK MANAGEMENT

Construction "'Bargains" May Well Backfire - Owners and Contractors Should Consider Potential Liabilities and Expenses

No, we're not talking about tunnels here - this "underground" refers to a "black market," "grey market" and unrecorded construction activity which do not attract the usual tax payments, assessments and permit fees related to legitimate work.

The underground economy is not a new phenomenon. However, there is widespread perception that in recent years it has grown to new levels in the Canadian construction industry. Among the main contributing factors are:

- The prolonged recession and reduced construction volumes in most parts of the country.

- The tight construction market has in turn fuelled efforts to reduce costs in order to be competitive for the available work - in short, to survive.
- Many people have plenty of time on their hands and are prepared to work for low pay if their earnings are not subject to payroll taxes and other deductions.
- "Downsizing" has reduced the number of inspectors.

- The risks of underground operators getting caught have been relatively small.
- A double standard exists in consumer demand. Many who would not dream of engaging in underground deals in their businesses or professions expect to obtain lower prices if they pay cash for work in their homes or cottages. Moreover, homeowners who are assailed by advertisements of leading retail stores stating "50% - 70% off and No GST/PST" tend to expect similar deals when buying construction services.

CONCEPTS IN THE UNDERGROUND ECONOMY

Not Just Housing

The main concentration of "underground" construction activity seems to be in the residential sector, especially with regard to repair and renovation work. The Canadian Renovators Council in the Canadian Home Builders' Association complains bitterly that its members are faced with unfair competition from those who quote lower prices because they are not paying taxes or the assessments forming part of the payroll burden. Although the GST is a relatively small cost item, its visibility is an irritant to homeowners, many of whom either instigate or accept cash deals in order to avoid paying it.

However, "underground" work is by no means encountered exclusively in residential renovation or new house building activities. "Cash on the dash" is also prevalent for certain activities in the industrial-commercial-institutional building (IC1) and engineering construction sectors.

As with residential work, unrecorded employment is easiest to perform on relatively small inside contracts of short duration. For example, renovations or new fit-ups in a strip mall or office building are typically done after hours so as not to interrupt business.

Tenants usually can deal with anyone they choose and so the work may not require a permit or is covered by the general permit obtained by the owner.

In reality, even large projects are often a collection of small contracts, especially in the ICI sector, because of subcontracts. There may be several levels of subcontracting down to the level where the labour is actually performed. Those higher up in the chain may well have no knowledge of whether or not the employment is reported.

Broader Definitions

Basically speaking, "underground" or "black market" construction is totally unreported and accordingly totally illegal. No taxes are paid on earnings. No contributions are made to employment insurance ("E.I."), CPP/QPP, workers' compensation, health insurance or other compulsory assessment plans. No building permit fees are paid. No federal, provincial or harmonized sales tax is remitted. The materials may be stolen goods. Welfare plans may also be ripped off.

Other procedures are often widely described as being "underground" but may be legal. For example, because of the recession and the competitive struggle between contractors and employees alike to get jobs, premium pay for overtime work and other fringe benefits may be dispensed with. Work may be offered and accepted on the basis of 48 hours' work for 35 or 40 hours pay. (Sometimes these practices are called the "grey market"). Depending upon whether or not they contravene provincial regulations, they may be quite legal. Again, regulations may not be enforced. Payroll deductions and employment assessments are remitted, albeit at a lower level.

The use of "Independent Sub-Contractors" is widely described by many in the industry as being "underground". In this case, the normal assessments levied on the earnings of an employee are not paid because the worker is an incorporated contractor. As such, he/she is an employer and does not pay for E.I., CIPP/QPP, workers' compensation, or health insurance, and is personally responsible for reporting earnings to the income tax authorities rather than having them mainly deducted at source.

The independent contractors do not have the normal social safety net protection accorded to employees in the event of injury or lay off. The cost of their labour is accordingly reduced by an appreciable degree. Contractors with employee workers may complain about "unfair competition" but the arrangement, under the terms of the existing legislation, is quite "legal".

Why Worry?

Everybody enjoys getting a bargain. However, there is a down side. Legitimate businesses in the construction industry are placed at a disadvantage when bidding against competitors who don't pay the required taxes or payroll deductions. There are increasingly loud cries for a "level playing field" and complaints that honest firms are going bankrupt.

Organized labour is concerned about workers being pressured into accepting working arrangements in which Employment Insurance and Workers' Compensation coverage is not provided and where there is no protection from dangerous or unhealthy working conditions.

And governments are losing millions and millions (some say billions) of dollars. Underground construction activity causes serious strains on our social programs:

- Overpayments are made to recipients of employment insurance, social assistance (welfare) and workers compensation who receive benefits they are not entitled to when they work underground and don't report their employment.
- Tax payments and contributions to Canada and Quebec Pension Plans are reduced, thereby increasing rates and costs to others.
- Existing standards in the area of health, safety, labour and environment are undermined.

All of which places additional pressure on Canada's ability to maintain its social, health care and educational programs.

Changes Are Coming

The above and other factors are driving governments and industry to take remedial actions. Perhaps relatively little has been done in the past in the hope that the problem would be solved by an improved

economy and a more buoyant construction program. However, demographic trends are such that the prospects for substantial increases in volume are not bright. Moreover, the underground element appears to be so well established that it has not diminished even in those areas where the construction program has expanded the underground market simply increases because there is more money around.

Indications of a greater determination to reduce the level of underground construction activity include:

- Revenue Canada's special audit program directed at the underground economy is reporting positive results in terms of prosecutions and increased tax revenues. Construction is a designated priority target. Bucking the downsizing trend, the staff of federal tax auditors has been substantially increased.
- Provincial Revenue Ministries are similarly expanding their tax audit activities. Revenue Quebec, for instance, estimates that it loses \$2 billion annually due to undeclared income and tax evasions. A special bureau has been set up with several hundred auditors to fight against tax evasion. A major Public Awareness program using television, print media, direct mail and stickers is being directed at "Under the Table" deals. All employers are being urged to "avoid getting involved in undeclared work and undeclared purchases of goods or services.' The ministry has sponsored a coordinated attack involving a number of other ministries and agencies.
- Agencies dependent upon payroll deductions and employment assessments for their revenues are liaising to an increasing extent. Examples now include Revenue Departments, Employment Insurance, Canada Pension Plan, Workers' Compensation Boards, Social Services (welfare) Offices, Companies Branches, Vital

Statistics and Canada Customs. The liaisons range from advising if individuals are receiving or are eligible for benefits, to database exchanges.

- New Employment Insurance regulations have increased penalties for infractions and now specifically target employers as well as workers. Employers involved in collusions to defraud the fund can be penalized **\$12,000** per offence. Company officers, directors and accountants can be penalized as individuals. About 1,500 are now working in E.I. Investigation & Control.
- All successful bidders on Ontario Government tendered contracts must now provide confirmation that their provincial taxes are in good standing before they can be awarded the contract.
- Human Resources Development Canada has sponsored a comprehensive study on the human resources and labour market implications of underground construction employment. This action was taken partly in response to representations from the Canadian Home Builders Association and the Canadian Office of the Building and Construction Trades Department (Unions) and is also supported by the Canadian Construction Association. All three bodies are represented on the project's steering committee.

Construction Contractors and Builders are being asked by Revenue Canada to report the names of all subcontractors and the amounts of these subcontracts for the previous calendar year. The program is voluntary for the present time but if the analysis of the returns indicates that the information is useful in terms of tracking unreported activity, a mandatory program could be imposed, in keeping with the 1995 Federal Budget. Some industry associations are advocating such action.

RISK MANAGEMENT FACTORS

The heading of this article suggested to Owners and Contractors that "underground" construction activity has added a new dimension to Risk Management and that they should guard against potential liabilities and expenses. This suggestion is based on the fact that the increased significance of the underground economy and its cost to society are in turn leading to widespread efforts to plug loopholes, track down transgressors, and increase the scope and size of penalties. Owners and Contractors may be unaware of "underground" practices on their projects but find themselves, nonetheless, liable. The following scenarios are offered as examples.

A Serious Accident

What if one or more people are killed or crippled on a construction project and it turns out that Workers' Compensation premiums have not been paid on their behalf? The prime contract typically states that the Contractor will provide evidence of compliance with workers' compensation legislation. The Contractor in turn normally requires letters from a subcontractor that they are in good standing with the Workers' Compensation Board ("WCB"), and most subs do likewise with their sub-subs. However, Independent Contractors are exempt. They have the option of applying for coverage or of buying their own accident insurance but few do so. Or maybe the workers are being paid on a cash basis by a sub-subcontractor and there is no coverage or exemption.

How does the recipient of a WCB letter of compliance know that all of the contractor's employees are covered? In the event of non-compliance and a lawsuit, there is a likelihood that all parties will be named, including the General Contractor and Owner. Potential liabilities include all benefits to the bereaved or injured, hospital and

ongoing treatment expenses, and a greatly increased WCB assessment rate.

In British Columbia, homeowners are deemed to be Residential Employers. The Workers' Compensation Act requires them to pay assessments for construction or repair workers for work lasting more than 24 working hours or more than an average 8 working hours a week, if the workers are not already registered with the WCB.

Contractor or Employee?

Many in the construction industry have incorporated and act as Independent Contractors. Examples include project and construction managers, superintendents, equipment owner-operators, independent truckers, and individual journeymen and renovators. They have done so for taxation benefits - e.g. the ability to write-off part of their home expenses as an office, the purchase of tools, computers and equipment, transportation expenses, the full cost of training courses etc. - and also because of an entrepreneurial spirit and the desire to be "independent". Others may have been employees who have been pressured into incorporating themselves by their employer so that he can bid lower prices - i.e. without having to allow for E.I., CPP/QPR, Workers' Compensation etc. - when using their services.

But can these "Contractors" still be deemed to be "Employees"? At least one Workers' Compensation Board has ruled that whoever engages workers to install construction materials or equipment must pay their WCB premiums, whether they are employees or contractors. Another deems construction managers to be employees. Revenue Canada also has ruled that in some cases Independent Contractors really are "employees" if they do not meet certain criteria. For example, if they have worked exclusively or very largely for the same contractor; or if they do not stand to risk suffering a loss on their contracts; or if they are

covered by the contractor's employees' benefit plan; they may be classified as "employees" In such cases, people may have filed their income tax returns as contractors for several years, only to have all of their accumulated "business expenses" disallowed and subject to tax.

Insurance Policies

Building regulations state that certain construction activities may only be performed by licensed personnel. If, for example, a gas heater was installed by an "underground" worker without the benefit of a permit or an inspection, and there is an explosion or fire, the Owner may find that his insurance claim is unsuccessful.

Caveat Emptor

Owners have always faced the problem of tracking down "fly-by-night" contractors who have done inferior work. However, in at least some cases, they have been successful in getting restitution be it in whole or in part. However, if Owners deal with no-name "underground" firms or workers on a cash basis, they have little, if any, recourse. Typically, they use "stealth vehicles" with no signage; they may well operate under false names; and there is usually no paper trail (the Owner may have purchased the materials for them). Work done without a permit is often inferior because those doing it know that it will not be inspected. Complaints cannot be lodged with any authorities because there is no building permit and, moreover, the Owner, having involved himself in an illegal deal, is himself in a culpable position.

Legitimate contractors and renovators delight in citing instances where they have been called in to repair botched up work done by "underground" operators. This is particularly so when the total cost exceeds that which they would have quoted for the work in the first place! On larger projects there is always the danger that, if prices have

been beaten down through several layers of subcontractors, the people actually doing the work cannot afford to do a proper job. This may only show up several years later in the form of heavy repair bills.

"Fair Wages"

Government construction contracts typically contain a set of Labour Conditions covering wages and hours of work. Public Works and Government Services Canada, for example, specifies that:

"All persons in the employ of the contractor, subcontractor, or any other person doing or contracting shall ...be paid fair wages ...and shall be paid for hours worked in excess of 8 hours a day or 40 hours a week at an overtime rate at least one and one-half times the wage-rates required..."

"Fair Wages" are ordinarily drawn from such provincial sources as the Quebec Construction Decree or the Manitoba Construction Industry Wages Act or, where there is no provincial regulation, "as determined through surveys of local labour markets". Such fair wage provisions are not always enforced as stringently as in the past, but there are pressures on governments to be more active in this regard. General Contractors are bound to such provisions and they are instructed to include them in the texts of any subcontracts. Any "grey market" practices could therefore make them vulnerable. Earlier this month, the Quebec Minister of Labour announced that his government, as part of the battle against the underground economy, would not award a construction contract of \$10,000 or more before checking with the Quebec

Construction Commission that the bidding contractor had a clean record for the previous two years.

Statutory Declarations

Statutory Declarations are widely used to accompany progress and final

payment claims. In them, senior company officers swear that they have personal knowledge that all accounts for which the Owner might be held responsible have been paid. In practice, subcontractors may sign the Stat Dec so that the general contractor and they will get paid. The small print in the standard forms issued by the Canadian Construction Documents Committee states that the declaration covers "in the case of the Contractor's/Sub-Contractors workers any debt arising out of collective bargaining agreements, legislation applying to workers' compensation, employment insurance, and minimum wage standards where applicable."

construction workers. Recipients therefore may decline an offer of short-term employment by a contractor if it jeopardizes their eligibility. Payment in cash or the banking of hours have reportedly been quite common accommodations.

The new E.I. regulations have a new basis for credits but attitudes may continue. Contractors should bear in mind the new focus on employers' penalties noted above. Also, the use of benefits from E.I., workers' compensation or welfare programs to subsidize construction wages has attracted increased attention by agency investigators.

all sectors, in both new and repair work, on both private and public projects, on jobs both small and large. Many Owners and Contractors are unaware of the implications and possible liabilities. The pendulum is swinging with the prospects of more stringent enforcement of certain regulations and more extensive audits. The potential liability and expenses impacting from "underground" activities should be borne in mind as important risk management factors. Legislation and regulations are subject to change and those of a provincial nature vary across Canada. A review of new and perhaps the existing requirements in this area may well be timely and prudent.

Employment Insurance

Eligibility for E.I. benefits is a valuable commodity for many

Conclusion

In recent years, "Underground" construction activities have grown in

By Don Chutter

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