

Memorandum

To : Honorable Jerome E. Horton, Chairman
Honorable Michelle Steel, Vice Chair
Honorable Betty T. Yee, First District
Senator George Runner, Second District
Honorable John Chiang, State Controller

Date : November 2, 2011

From : Randy Silva, Acting Chief, Investigations and Special Operations Division
Legal Department

Subject : **Board Meeting, November 15-16, 2011**
Agenda Item P1
California's Underground Economy Centralized Intelligence Partnership Concept

California government has faced unprecedented cuts due to a struggling national economy. The underground economy further hinders California's government services as well as its business community by taking away legitimate business from law-abiding California entrepreneurs who pay their taxes that contribute to government services which are made available to California taxpayers.

Initial research indicates that a collaborative, strategic, targeted and focused effort to combat the underground economy would create a synergy among the various enforcement agencies and impacted California industries. This collaborative effort would significantly increase the State's efficiency and effectiveness in recapturing revenue lost to businesses operating illegally in the State of California. We have an opportunity that could ultimately generate up to one billion dollars annually in additional revenue for California, while at the same time level the playing field for California businesses.

To meet this objective, the formation of a Centralized Intelligence Partnership (CIP) is proposed to be made up of representatives including, but not limited to, the Board of Equalization, the Franchise Tax Board, the Employment Development Department and the Office of the Attorney General. We cannot, however, fully leverage this effort without engaging all major stakeholders, which includes those California industries and some labor organizations that are experiencing significant fiscal impact as a result of the underground economy.

Each CIP partner agency would dedicate human capital and intelligence in a collaborative effort to collect and analyze relative data with the objective of targeting our collective enforcement and prosecution resources to arrest this illegal activity within specific industries. This strategy has proven productive and efficient in the investigation of Cigarette Tax Evasion and in a number of other state and federal efforts.

While there are several different entities currently working on various aspects of the underground economy, no one entity is responsible for coordinating these efforts. As a

result, there is no synergy in the collection and analysis of data, or in the development of strategic and focused investigation and prosecution efforts.

By increasing revenues through a more efficient, collaborative effort, we have the potential to improve California's legitimate business environment, while restoring and/or increasing the services that have historically been provided to California's taxpayers.

The attached exhibits provide some important facts and analysis regarding the underground economy.

Exhibit A – *The Underground Economy Cycle* – Illustrates the negative impact that the Underground Economy has on Revenue Generating Economy in our State.

Exhibit B – *Underground Economy Estimated Revenue Loss to California by Industry* – Reflects the estimated revenue loss to the California economy, by industry, when goods and services are purchased from unlicensed or illegal sources. In addition, it quantifies the losses to the State in unreported employment taxes caused by employers who disregard labor laws to gain an unfair advantage over law-abiding employers.

Exhibit C – *General Statistics Related to Underground Economy Losses* – Provides an “at-a-glance” view of the impact of the underground economy on California, emphasizing dollars lost.

Exhibit D – *Government Resources Currently Engaged in Combating the Underground Economy* – Shows the current efforts and resources in place to combat the underground economy. Chart ‘A’ lists the task forces that focus on investigations and enforcement of illegal/underground activities in California. Chart ‘B’ lists the various investigative resources being used by California state agencies.

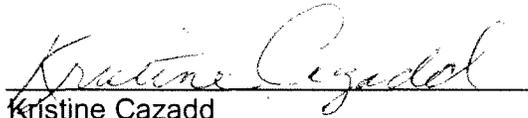
Exhibit E – *Projected Tax Revenues Captured: based on the Tobacco Products Collaborative Investigations and Enforcement “Big Pinch” Task Force (AG; BOE; Bureau of Alcohol, Tobacco, Firearms and Explosives [ATF]; and the US Department of Justice: Office of the Attorney General)* – BOE's joint investigative effort with the ATF and the AG (“Big Pinch”) identified \$282 million in other tobacco products (OTP) tax loss—\$103 million for period of tax loss, and \$179 million in projected tax loss. These are revenues that can be realized through collaborative enforcement efforts in combating the underground economy. Even if the state were to only capture 5% of the current estimated underground economy revenue loss of \$60 billion, California would realize an increase of \$3 billion annually.

Exhibit F – *Collaborative Investigations Charts* – (front) organizational chart for the Centralized Intelligence Partnership, (back) flowchart for the intake, evaluation and processing of complaints and allegations received by the Statewide Evasion Hotline. – These charts provide a proposed organizational structure and work process framework for the Centralized Intelligence Partnership.

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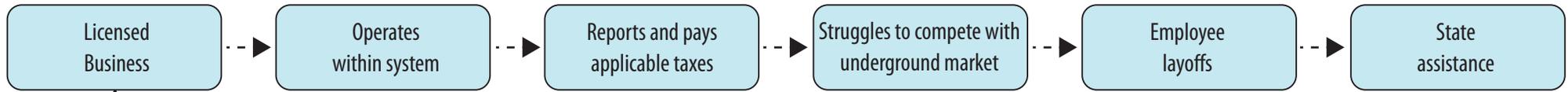
Attachments

Approved:

A handwritten signature in cursive script, reading "Kristine Cazadd", written over a horizontal line.

Kristine Cazadd
Executive Director

Underground Economy Cycle

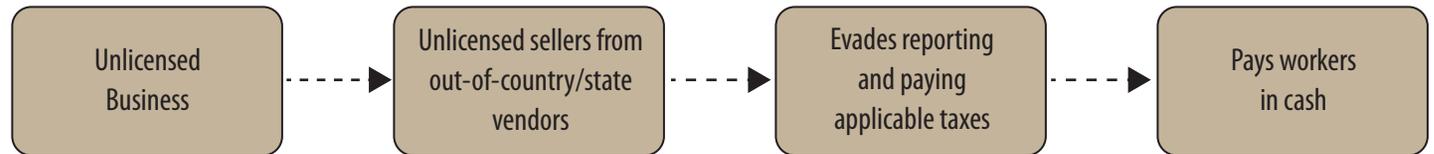


Revenue Generating | **ECONOMY**



Services supported by California revenues:

EDUCATION • SOCIAL SERVICES • LAW ENFORCEMENT • JUDICIAL • HEALTH SERVICES • PRISONS • PARKS • COUNTY HOSPITALS
 TRANSPORTATION SYSTEM • DISEASE CONTROL • HUMAN RIGHTS • DEFENSE • EMERGENCY RESPONSE • FIRE SUPPRESSION



UNDERGROUND | **ECONOMY**

Estimated Total Annual Loss: \$60 Billion



Underground Economy Estimated Revenue Loss to California by Industry*

This exhibit reflects the estimated revenue loss to the California economy, by industry, when goods and services are purchased from unlicensed or illegal sources. In addition, employers who disregard labor laws gain an unfair advantage over law-abiding employers resulting in losses to the State in unreported employment taxes.

Counterfeit/Piracy

Industry	Estimated Revenue Loss
Prescription Drugs	\$ 5.13 billion
Movies	3.27 billion
Music	1.64 billion
Computer Software	1.25 billion
Cable/Satellite TV Signals	850 million
Fashion	615 million
Currency	24 million
Electronic Equipment	13 million

Labor Violations

Industries – Common Violators	Aggregate Loss 2005-2010
<ul style="list-style-type: none"> • Agriculture • Construction • Pallet build/repair • Car Wash • Garment • Janitorial • Restaurant • Auto Body • Horse Racing 	\$ 47 Million ¹

¹ Amount of tax assessments on \$300 million in unreported wages.
Source: California Economic & Employment Enforcement Coalition,
December 2010: White Paper.

Illegal Activities

Industry	Estimated Revenue Loss
Illegal Drug Trafficking	\$ 28.14 billion
Prostitution	\$ 2,000/per arrest
Identity Theft	\$ 4.84 billion
Illegal Gambling	\$ 19.63 billion
Human Trafficking	14,500 – 17,500 U.S. cases/year
Cigarette & Tobacco	\$ 650 million

*Numbers calculated using available global or U.S. estimates, by industry. Comprehensive source list and calculations are available upon request.

General Statistics Related to Underground Economy Losses

This exhibit provides an “at-a-glance” view of the impact of the underground economy on California, with an emphasis on dollars lost.

Description	Amount	Source
Underground Economy as a Percentage of Gross Domestic Product (GDP)	8-9%	The Wall Street Journal – Classroom Edition: <i>The Underground Economy</i> , April 2005
California GDP, 2009	\$1.9 trillion	U.S. Bureau of Economic Analysis: <i>Data Table on GDP by State, 2010</i>
Estimated Total Annual Revenue Loss	\$60-140 billion	Contractors State License Board, Press Release, 03/17/2005: <i>Multi-Agency Operation Highlights Dangers of California's Underground Economy</i>
Estimated Annual Loss of Income Taxes	\$6.5 billion*	Legislative Analyst's Office, February 2005: <i>California's Tax Gap</i> ,
Unreported Taxable Wages Found through Enforcement Action, 2005-2010	\$300 million	California Economic & Employment Enforcement Coalition, December 2010: <i>White Paper</i>
Amount of Assessment on Unreported Wages, 2005-2010	\$47 million	California Economic & Employment Enforcement Coalition, December 2010: <i>White Paper</i>

* This figure was calculated for purposes of quantifying the Tax Gap. Approximately 80% of this total, \$5.2 billion, is considered to be related to the underground economy. The remainder of the loss is attributable to over-claimed deductions and taxpayers who fail to file returns.

Government Resources Currently Engaged in Combating the Underground Economy

The charts below reflect the current efforts in place to combat the underground economy. Chart ‘A’ shows the task forces that focus on the investigation and enforcement of illegal/underground activities in California. Chart ‘B’ shows the various investigative resources being used in California state agencies.

Chart A – Task Forces

Group ¹	Members	Purpose
Joint Enforcement Strike Force (JESF)	Employment Development Department (EDD) Department of Industrial Relations (DIR) Department of Consumer Affairs (DCA) Department of Insurance (DOI) Franchise Tax Board (FTB)	Share information and conduct joint investigations
Tobacco Section	Sponsored by the Federation of Tax Administrators in cooperation with agencies of 13 Western States	Combat unlicensed/unstamped cigarette and tobacco products trafficking
High Intensity Financial Crimes Area	Local and state government law enforcement agencies	Solicit local/state government support in pursuing cases
Yolo County Investigator's Meeting	County law enforcement	Solicit local support
Economic and Employment Enforcement Coalition (EEEC)	US Department of Labor (USDOL) EDD Division of Labor Standards Enforcement (DLSE) Division of Occupational Safety and Health (OSH) Contractors' State License Board (CSLB)	Unreported wages and unsafe working conditions

Chart B – Investigative Resources

Agency	Investigative PYs ²	Staff Costs ³
Board of Equalization	108	\$ 16.2
Department of Industrial Relations	391	58.7
Department of Insurance	118	17.7
Department of Motor Vehicles	374	34.2 ⁴
Department of Public Health	140	21.0
Employment Development Department	56	8.4
Franchise Tax Board	Not Provided	Not Provided

¹ The Board of Equalization partners with all groups listed.

² PY = Personnel Years.

³ Costs are estimated at an average of \$150,000 per PY; costs are in millions.

⁴ Reflects actual budgeted costs.

Projected Tax Revenues Captured: based on Tobacco Products Collaborative Investigations and Enforcement “Big Pinch” Task Force (AG, ATF, BOE, US Attorney)

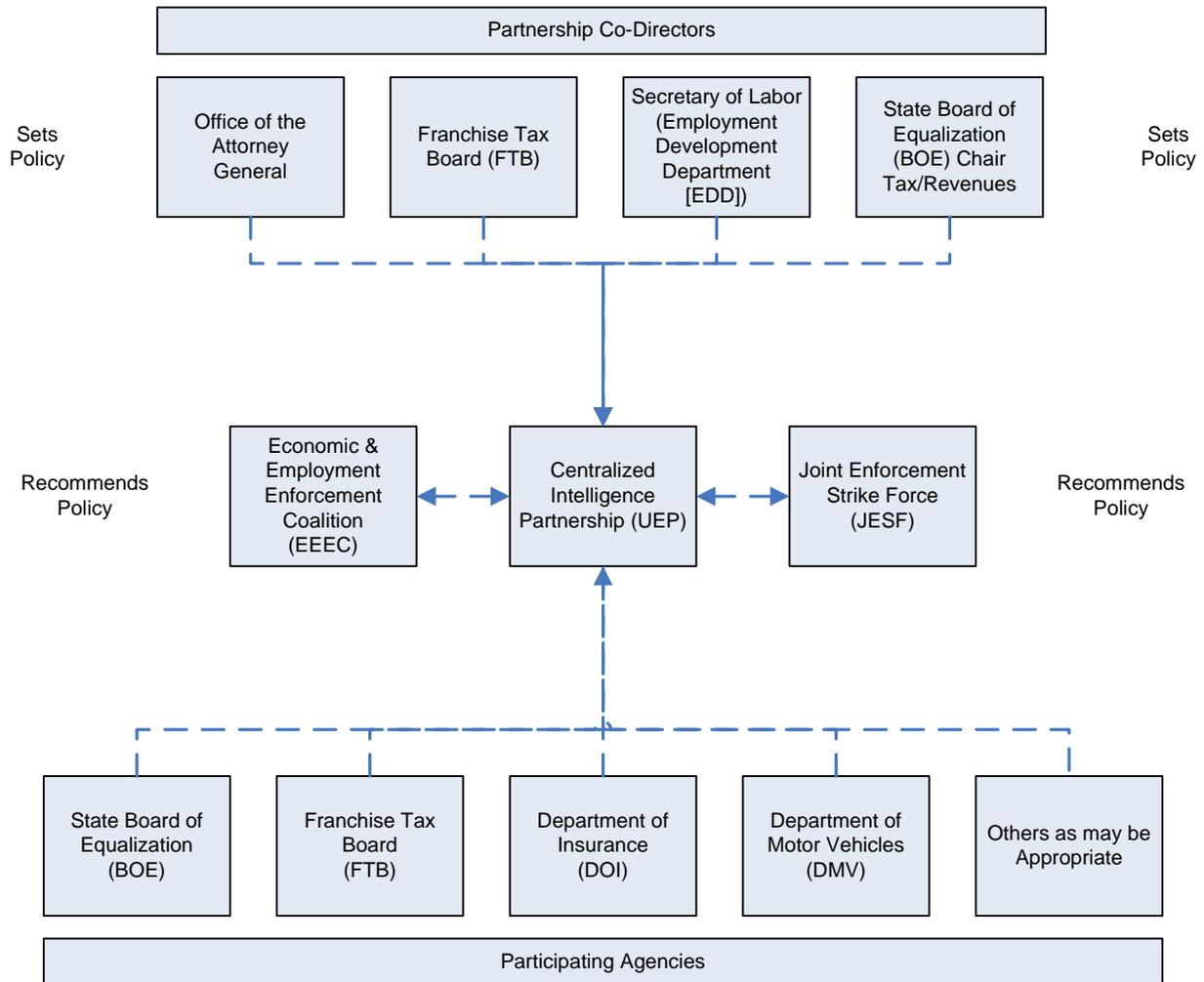
BOE's joint investigative effort with the ATF and the AG (“Big Pinch”) identified \$282 million in OTP tax loss—\$103 million for period of tax loss, and \$179 million additional in projected tax loss.

Case Number	Estimated Tax Loss	Estimated Taxable Measure	Period of Tax Loss	Additional Tax Loss Projected thru 6/30/11 ¹	Total Tax Loss Captured
778	\$ 470,362	\$ 1,005,906	Jul-04 to Dec-04 & Oct-05 to Feb-06	\$ 2,488,099	
594	\$ 265,486	\$ 567,764	Feb-04 to Oct-06	\$ 403,759	
595	\$ 353,109	\$ 755,152	Jan-04 to Oct-06	\$ 521,223	
772	\$ 1,704,443	\$ 3,645,088	May-06 to Oct-06	\$ 14,256,911	
768	\$ 351,773	\$ 752,296	Jan-04 to Oct-06	\$ 519,252	
757	\$ 1,018,723	\$ 2,178,621	Jan-04 to Oct-06	\$ 1,503,735	
759	\$ 13,364,131	\$ 28,580,263	Sep-04 to Oct-06	\$ 25,796,546	
770	\$ 2,771,648	\$ 5,927,392	May-04 to Feb-06	\$ 7,330,675	
752	\$ 16,277,633	\$ 34,811,019	Jan-04 to Dec-05	\$ 40,821,142	
756	\$ 1,373,941	\$ 2,937,351	Aug-05 to Mar-08	\$ 1,437,934	
754	\$ 2,457,083	\$ 5,254,668	Mar-04 to Aug-08	\$ 1,304,773	
758	\$ 3,777,472	\$ 29,512,424	Sep-04 to Apr-08	\$ 10,204,457	
766	\$ 5,370,452	\$ 11,487,823	Aug-05 to Dec-07	\$ 6,741,767	
755	\$ 3,870,986	\$ 8,278,412	Jan-04 to Mar-08	\$ 2,542,787	
751	\$ 554,454	\$ 1,195,400	May-06 to Feb-08	\$ 875,707	
764	\$ 605,805	\$ 1,296,542	Mar-05 to Aug-08	\$ 413,924	
767	\$ 528,420	\$ 1,132,030	Sep-06 to Apr-08	\$ 861,124	
771	\$ 1,882,687	\$ 4,061,538	Mar-04 to Apr-08	\$ 1,235,828	
763	\$ 3,350,646	\$ 7,376,542	Sep-05 to Aug-08	\$ 2,747,475	
762	\$ 1,507,621	\$ 3,269,384	Sep-06 to Aug-08	\$ 1,826,578	
678	\$ 2,947,174	\$ 6,472,390	May-07 to Jun-08	\$ 6,616,262	
704	\$ 11,771,249	\$ 25,782,183	Aug-06 to Nov-09	\$ 4,408,818	
609	\$ 6,186,855	\$ 13,231,084	Nov-03 to Jun-05	\$ 20,474,573	
632	\$ 8,351,981	\$ 17,861,379	Jun-04 to Mar-06	\$ 21,710,344	
777	\$ 526,943	\$ 1,275,091	Apr-09 to Apr-10	\$ 469,292	
646	\$ 503,943	\$ 1,077,723	Jan-05 to May-07	\$ 750,482	
697	\$ 960,634	\$ 2,128,592	Oct-07 to Jun-09	\$ 901,672	
Totals	\$ 103,105,652	\$ 221,854,055	5 years	\$ 179,165,139	\$282,270,792²

¹ This amount was calculated from the end of the period in issue through June 30, 2011, at the prevailing OTP tax rate assuming the businesses continued their same operation.

² If the state were to capture 5% of the current estimated underground economy revenue loss of \$60 billion, California could see an increase of \$3 billion annually.

Organizational Chart for Centralized Intelligence Partnership



Process Flow for Centralized Intelligence Partnership

All complaints and allegations related to tax evasion, licensing, labor, insurance fraud, payroll tax and workers compensation, etc., that are received by the Statewide Evasion Hotline are directed to the Central Intake Clearinghouse (CIC).

