

Little Hoover Commission – Underground Economy
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1. *How does the Board of Equalization's (BOE) Investigations and Special Operations Division identify businesses with potential large or serial violations and how does it conduct its investigations and enforcement activities?*

To ensure California businesses comply with tax laws and properly report and pay taxes due, the BOE routinely conducts audits for all its tax programs. During the conduct of an audit, a BOE auditor may find indicators of criminal tax fraud. It is from these audits that referrals are made to the Investigations Division (ID) for possible criminal investigation of tax evasion. Felony fraud occurs when the unreported tax liability is \$25,000 or more within a consecutive 12-month period. However, cases investigated by ID typically involve amounts in excess of \$75,000. For example, the current projected tax per investigative case for cigarette tax is approximately \$922,000, sales and use tax is \$578,000 and tobacco tax is \$632,000. These estimates are based on a five-year average of prior billed cases by tax program.

Identification of businesses committing tax fraud is also derived from leads provided by various entities—general public, confidential informants, industry, government agencies, law enforcement, ID's inspection program, organizations such as the High Intensity Financial Crimes Area (HIFCA), and from related investigations. However, the large-dollar evasion cases are more readily identified and successfully prosecuted when ID shares data and collaborates with other law enforcement entities such as the Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF). For example, ID has been collaborating with the U.S. Attorney's Office, ATF and the California Department of Justice (DOJ) on a specialized tobacco task force that has identified over \$100 million in tax loss. Of that amount, over \$30 million in restitution to the BOE has been ordered and 22 defendants have been convicted to date.

Whether collaborating with other enforcement agencies or on its own, ID's investigative process includes initial investigation of leads, surveillance activities, development of probable cause for search warrants, execution of search warrants, and issuance of subpoenas to acquire third-party information (e.g., used car data from auction houses to identify evasion of sales tax by used car dealers). UPS and other carrier data of tobacco shipments into California from out of state have also been subpoenaed to help detect evasion of excise and sales taxes. With supporting documentation in hand, ID Investigators can then prepare prosecution packages for the District Attorney, Deputy Attorney General, or Assistant U.S. Attorney, depending on the prosecutorial jurisdiction, and work alongside the prosecutor to provide testimony or other investigative assistance until the final adjudication of the case. ID's felony investigations are separate from the BOE's civil audit and compliance activities; however, as applicable, a corresponding civil audit is completed and billed for BOE cases related to criminal prosecution.

BOE's tobacco enforcement program requires ID's inspection teams to conduct statewide inspections for compliance with the tobacco tax laws. Approximately 10,000 inspections are conducted annually of retail, wholesale and distributor businesses selling tobacco products. These inspections can reveal repeated violations that may reflect significant and highly organized tax evasion. If this occurs, ID initiates an investigation.

Additionally, ID will evaluate various data to identify patterns in certain industries such as used car dealerships or restaurant franchises for potential tax fraud. For example, ID recently referred several cases to the State Attorney General's Office involving tax evasion by specific fast-food chain operators in the greater Los Angeles area that were evading millions of dollars in unreported tax. This tax evasion was notably egregious given their ability to accurately track sales using a sophisticated point-of-sale system. ID is also currently working with DOJ to jointly identify and pursue high-value criminal cases to more efficiently prosecute businesses operating in the underground economy.

Publicizing convictions is used as a tool by the BOE to help deter the business community from participating in underground economic activities and to bring this illicit activity to the attention of the public at large, as tax evasion/white collar crimes tend to go un-noticed. For every criminal conviction attained from its investigations, ID prepares a press release highlighting the suspect, crime, investigative collaborations, revenue loss, and punishment or judgment ordered by the court. A broad campaign has also been initiated by the BOE to help educate the general public regarding the damage not only to the state but its citizenship. We believe that once California taxpayers understand the consequences of underground economic activities and how it impacts them personally, they will be less tolerant of such illicit activities and be aptly motivated to report violations.

2. *In what ways is the underground economy evolving, such as expansion into new areas, technological advancements or general increase or decrease in activity? How have trends changed the work of the division that you lead?*

Although estimates regarding the extent of the underground economy vary widely depending on the evidence used, recent research shows that the underground economic activity has grown significantly since the last report on this topic from the Little Hoover Commission in 1985. At that time the Commission estimated California's underground economy to be \$30 or \$45 billion. More recent estimates present these figures as \$60 to \$140 billion.ⁱ

Similar to legitimate businesses, the underground economy also evolves on the basis of supply and demand, profit vs. risk, available resources, and fiscal health. The economic downturn in California, coupled with the explosion of free trade and economic integration throughout the world, has created the perfect environment for organized underground economic activities to thrive:

- There is a demand for lower-cost goods (e.g., counterfeit or untaxed products are entering into legitimate distribution networks);
- Untaxed products provide a higher profit margin;
- Potentially low risk (e.g., to keep goods moving through the Port of Los Angeles, less than one percent of shipping containers are physically inspected)ⁱⁱ; and
- Resources are easily accessible (e.g., new technologies can quickly produce counterfeit products: music, videos, accessories, pharmaceuticals, etc.).

Technology, now more than ever, plays a significant role in the growth of the underground economy. With computerized systems and other electronic devices readily available, counterfeiting intellectual property is easier and faster, products quickly reach the market, and detection of illicit activities becomes more difficult. For example, California's earlier cigarette tax stamp was counterfeited using computer technology, which ultimately resulted in California redesigning its stamp to incorporate encryption that could not be reproduced. We also know that counterfeit entertainment items such as CDs and DVDs, sold at highly discounted prices, contribute to lost

income and sales taxes. The drop of legitimate product sales also leads to job losses through the chain of the industry's production and distribution (e.g., everyone from sound engineers and cameramen to retail clerks that sell the CDs and DVDs). Informal workers who are paid lower wages, misclassified, or not reported, etc. comprise up to 17% of California's workforce according to the UCLA study

As investigative cases become more complex and perpetrators more sophisticated, expanding outside the borders of California, ID finds that the collaboration with other enforcement agencies becomes more important to effectively combat organized underground economic activity.

3. *What does the team created by AB 576 bring to the state's efforts that were previously missing? How will data-sharing that is enabled by the legislation assist agencies in their work?*

AB 576 creates the Revenue Recovery and Collaborative Enforcement Team (RRACE Team), comprised of BOE, FTB, EDD and DOJ, and allows the RRACE Team to share intelligence, data, documents, information, complaints, and lead referrals for the purpose of collaboratively investigating and prosecuting criminal tax evasion associated with the underground economy. Previously, each agency primarily investigated such illegal activities in silos rather than collectively. The lack of effective communication among agencies likely led to missed opportunities to capture state revenues that were otherwise lost. This legislation provides clear direction to the departments of the RRACE Team to share data in its effort to investigate and prosecute criminal tax related violations without having to navigate through the multitude of Memorandums of Understanding between departments that in some cases have limits to information shared.

The shared data will be used to consolidate and coordinate multi-agency efforts to:

- Provide the framework for agents from various departments to work together on a daily basis, thus maximizing existing state investigative resources;
- Provide the framework for RRACE Team monthly meetings of the four department's investigative chiefs to discuss leads for criminal investigative collaborations, as well as refer those leads that are best suited for other existing criminal or civil enforcement authorities;
- Allow joint review of collective intelligence to improve identification of high-value cases, as well as disclosure of information to limit participating agencies' exposure to fraudulent refund and benefit fraud;
- Foster the identification of emerging trends for all programs;
- Help ensure collaborative investigations and prosecutions capture all violations;
- Open more opportunities for collaborations with federal, state and local partners to leverage enforcement efforts and avoid duplication in addressing underground economic activities; and
- Reduce prosecution costs through the consolidation of cases that go to a local prosecutor or Attorney General's Office.

In short the enhanced data sharing by the AB 576 Team will remove existing barriers within state revenue programs and provide a coordinated, unified, effective and impartial effort to combat and reduce criminal tax-related activities in California's underground economy.

4. *What potential challenges may arise for the new team, how are the member agencies planning to respond to those challenges, and what help could they use from other state leaders or organizations?*

As with any new program or process, there will always be some challenges to overcome. The first and most important challenge will be to change the focus of the participating agencies' enforcement efforts from separate agency program priorities, focused on their own specific operations or constituencies, to a broader effort that singles out the most egregious and complex underground economic activities causing the greatest harm to California's tax base and its citizens. A change in mindset from "our program" to the "state's interest" is a must. Addressing this challenge can only be effective if each participating agency embraces this concept and sets aside institutional barriers.

Secondly, we need to get the cooperation and support from California's key industries that are most vulnerable to tax fraud, labor violations, and organized counterfeiting and piracy. Data and assistance from each impacted industry will enable the RRACE Team to more readily identify and combat large organized underground activities.

While some of California's industries currently utilize private investigative firms to identify piracy, they do not have the authority to prosecute violators and must, therefore, refer these cases to law enforcement for prosecution. In turn, law enforcement may not be familiar with all licensing and tax violations, which, as a consequence, leaves gaps in revenues captured. RRACE provides an effective framework within which these private firms and law enforcement can work in concert to more effectively counter illicit underground activities and more completely capture lost revenues.

Additionally, RRACE will face the challenge of effectively coordinating its enforcement efforts with those of existing task forces already dealing with specific areas of the underground economy. For example, the Joint Enforcement Strike Force (JESF) and Labor Enforcement Task Force (LETF) deal primarily with labor issues related to the underground economy, not broader criminal tax evasion concerns. While both JESF and LETF play a significant role in protecting California's workers from unscrupulous business practices, their focus is primarily on civil penalties rather than complex, lengthy criminal cases. This may be due in part to the fact that the task forces lack statutory authority and necessary resources to pursue criminal evasion of sales and income taxes. RRACE does not intend to duplicate current task force efforts, but rather coordinate criminal investigations to encompass all state programs and thereby eliminate gaps that organized criminals easily exploit. But to achieve any measure of success in combatting the underground economy, we again emphasize that the mindset must be not who gets "credit" but how well we collaborate to ensure that all program violations are addressed and lost revenues captured.

The need for collaboration between government, business and labor has never been greater. We need to engage California industries, labor organizations, and other enforcement entities and ask that they take a proactive stance in combating the underground economy by partnering and collaborating with RRACE. The assistance of government leaders to encourage partnership by entities affected by the underground economy would support the efforts of RRACE.

We also need to take advantage of the value of publicity for this program. Educating the public organizations, businesses, law enforcement and others affected by the underground economy about this coordinated state effort, would serve as a deterrent to those operating in the underground economy. Any assistance from government leaders to give the program more visibility will improve the program's effectiveness in its fight against organized underground economic activities.

5. ***With a problem as complex and ever-changing as the underground economy, what principles should the state's top policymakers use in setting realistic expectations and metrics for measuring success?***

When establishing a new program, it can be difficult to select, design and implement appropriate expectations and useful metrics without historical data to guide the process. The goal should be to establish metrics that support sound decision-making. Critical questions to consider include: what to measure, how to measure, who should analyze the data, what to do with the data, and how to diagnose and react to performance issues.

Metrics should not solely speak to revenue, but give adequate value to what it takes to reach convictions of egregious tax evasion cases and serial violations of labor laws. The RRACE governance team will work with other member agencies to implement the following principles:

- Metrics should be clearly defined – metrics should enable program owners to monitor performance, diagnose variations/problems, and make effective course corrections;
- Metrics for program objectives should be created to determine, assess and measure value of the task/output towards the goal;
- Operational metrics should be added (e.g., measuring volume, responsiveness and efficiency);
- The means of collecting the metric should be considered: If a metric is easy to collect, but does not provide value, it can be a waste of resources; whereas, a metric that is hard to collect but provides significant insight may be worth the investment to collect;
- Some metrics should be designed to provide leading indicators of future performance problems – this provides early warning about possible issues so corrections/adjustments can be made;
- Performance targets should be reasonable so that each metric relates to a realistic and achievable performance target; and
- Appropriate monitoring should be established – the frequency of monitoring should be related to results, goals and deliverables.

It is also important to note that it is difficult to assign specific metrics to investigative functions because traditional measurements (quantity, etc.) do not reflect the true value of the work being accomplished. The objective of this task force is to focus on the most egregious cases, which take significant time to complete and may not result in a marked increase of prosecuted cases.

It is critical that the right people are looking at the performance data – that is, people with program knowledge and authority to take action. Using both objective-based and operational-based metrics is the best way to provide a full picture of program effectiveness. Ongoing measurement is the basis for continuous evaluation, improvement and accountability.

6. *What barriers exist that prevent successful enforcement of current state laws? Are there additional opportunities to improve coordination among state entities?*

Current cultural barriers that exist within institutions (see item 4 above) could potentially hamper successful enforcement activities of AB 576. RRACE will not be effective unless these barriers are set aside.

AB 576 allows for the sharing of intelligence between the agencies of the RRACE Team. However, the sharing of IRS data between these same agencies is prohibited even though each agency has authority to acquire and use IRS data. This limitation of IRS data sharing could impede or cause delays in the investigation of criminal investigative leads otherwise afforded from sharing this data.

Currently, state agencies often compete for the same resources. The ability for agencies to coordinate requests for resources dedicated to a specific unified effort would vastly improve collaborative programs such as RRACE.

Increased efficiency of the state's various tax enforcement programs could also be realized if the same classification was used by all state program investigators. While the process of a criminal investigation is similar from state program to program, there is a disparity in the level of personnel used by the various agencies. A consistent use of the same level of investigative personnel would afford investigators the opportunity to lateral from one state agency to another. This would prove beneficial in collaborative programs such as RRACE by bringing the institutional knowledge from one agency to another that, in turn, would make criminal investigations more efficient from such shared knowledge. In short, the use of a common classification system would promote the state's retention of a skilled investigative workforce comprised of staff members that are equally equipped across all agencies to perform the duties of their respective positions.

ⁱ California and the Underground Economy, 2013. UCLA Labor Center.

ⁱⁱ Port of Los Angeles maritime statistics (www.portoflosangeles.org/maritime/stats.asp).