

COMMISSION ON CALIFORNIA STATE GOVERNMENT ORGANIZATION AND ECONOMY

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*Executive Director*

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A REVIEW OF SELECTED TAXING AND  
ENFORCING AGENCIES' PROGRAMS  
TO CONTROL THE UNDERGROUND ECONOMY

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AUGUST 1985

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Honorable Patrick Nolan  
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PHILLIP D. WYMAN  
 Assemblyman

RICHARD C. MAHAN  
 Executive Director

Dear Governor and Members of the Legislature:

In response to a request by Governor Deukmejian, our Commission initiated a major study of California's underground economy to identify ways the State can be more effective in deterring these activities through improved detection and enforcement.

There are many ways that the underground economy operates in California and throughout the country. It certainly includes criminal activities such as drugs, gambling, and prostitution where billions of dollars change hands illegally without taxation. The Commission's study, however, focused on the largest segment of the underground economy which involves self-employed persons and employers and employees who pay or receive cash for work performed or for goods sold without withholding proper income, payroll, or sales taxes, and without filing the appropriate reports to the various taxing agencies.

These activities each year account for up to \$40 billion in otherwise legal business transactions in California without a single dime of taxes being paid to the State government. Experts estimate that California loses more than \$2 billion each year in income taxes alone because our taxation and enforcement system is unable to catch these tax cheaters.

The effect on State government, though, is not limited to the hundreds of millions of dollars in lost income, sales, and payroll taxes. The participants in the underground economy also fraudulently file for welfare payments. Furthermore, many of these individuals also have the Medi-Cal program pay for their health care. As a result, the cost of operating these State government programs is increased by millions of dollars annually. Additionally, there are no contributions to unemployment insurance, disability, or Social Security although claims against these funds continue, frequently by the worker receiving his or her wages in cash.

Government and the taxpaying citizens of the State are not the only ones that lose from the existence of the underground economy. Employees involved in these illegal transactions lose because they do not receive benefits such as retirement and health insurance. And law abiding employers lose because of the unfair competition that results.

There are at least four State taxing and labor agencies performing some level of investigation and audit of the underground economy. And yet, experts say that these illegal activities continue to grow. The inability of these agencies to date to effectively and efficiently stop, or at least deter, the underground economy led our Commission to review the laws, enforcement tools, organization, and management of the State's resources combatting the underground economy, and develop recommendations for improvements.

Because of the unique problems associated with detecting and enforcing laws designed to prevent the underground economy, our Commission appointed a Blue Ribbon Study Advisory Committee to provide valuable insights and guidance on this study. Virtually all knowledgeable parties were represented including the Chairmen of the Senate Committee on Industrial Relations and Assembly Committee on Labor and Employment, the directors of the various State taxing and regulatory agencies, the U.S. Internal Revenue Service, management and employer organizations, employee and union organizations, attorneys specializing in labor and taxation, and a partner of a Big-Eight accounting firm.

In general, the Commission and its Blue Ribbon Study Advisory Committee concluded that the State can and must do much more to deter the growth of the underground economy and eliminate its activity in many areas.\* Among the Commission's specific findings are the following:

- The level of voluntary compliance in paying State taxes and filing reports with the appropriate tax and collection agencies appears to be declining. The value of enforcement in encouraging voluntary compliance has not been adequately recognized.
- Taxing and enforcement agencies have not taken full advantage of the value of publicity in obtaining additional compliance.
- Currently available State information is not adequately shared between agencies; information which is shared is frequently not used to stop the underground economy. Finally, agencies are not identifying and using new sources of information.

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\* Although the Study Advisory Committee members were all in general support of the report's findings and recommendations, certain members do not support certain recommendations.

- Although audits have about a ten-to-one benefit to cost ratio, auditor staffing in some agencies has decreased.
- Collection backlogs have more than doubled in the last four years and now exceed \$1 billion.
- Agencies' audit selection criteria do not adequately consider the underground economy or the value of increasing voluntary compliance.
- Department of Industrial Relations' staff have not been adequately trained in methods to reconstruct how extensive certain past cash-pay violations were.
- State agencies are not sufficiently pursuing criminal penalties which would increase deterrence.
- State agencies are not using cross-agency penalties which would help maximize deterrence and recoveries.
- Enforcement against employees involved in cash-pay is inadequate.
- Lack of a single revenue and taxing agency contributes to many of the above stated problems, and results in conflicting or dissimilar objectives which limit the overall effectiveness of State enforcement of the underground economy. Additionally, multiple tax and enforcement agencies result in some level of duplication.

To improve the organization, management, and efficiency of the various State taxing and enforcing agencies' programs to control the underground economy, our Commission and its Blue Ribbon Study Advisory Committee have developed 20 recommendations which include the following:

1. The Governor and Legislature should consider reorganizing some or all State taxation responsibilities; the level of reorganization should be based upon a detailed study by a team of multi-disciplinary experts.
2. Until reorganization occurs, the Governor and Legislature should establish a Multi-Agency Task Force to conduct complete audits and investigations of blatant tax and cash-pay violations. The activities of the Task Force should be publicized extensively.
3. A standing committee of all appropriate agencies should be established to continuously study opportunities for sharing information, identifying new sources of information, improving formats, and eliminating obstacles which prevent the sharing of information.
4. On a test basis, auditors and investigators should be trained on the basic requirements of other agencies and, where appropriate, be given authority to enforce other agencies' laws.

5. The Governor and Legislature should reevaluate the staffing levels needed by audit, investigative, and enforcement units, and, where cost-beneficial, increase levels.
6. The level of prosecutions should be increased and convictions actively publicized.
7. The Governor and Legislature should authorize a graduated penalty system to provide more severe penalties for repeat violators.
8. State tax and enforcement agencies should consider expanded use of automatic computer-generated citations based upon work done by other agencies.
9. The State should amend current statutes to require that any contracts using any form of State monies be awarded based upon criteria that includes an assessment of the contractor's past compliance with tax and labor laws, particularly cash-pay related statutes.

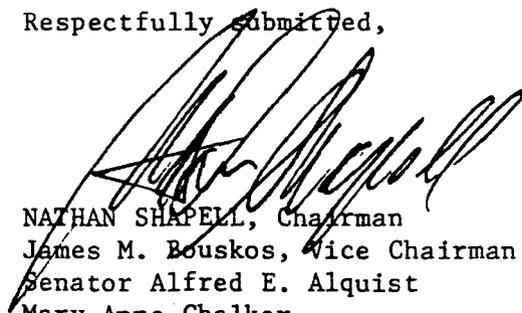
Our Commission believes that the implementation of these recommendations and others presented in Chapter VII of this report will increase voluntary compliance, deter growth of the underground economy, substantially increase the effectiveness of the State's monitoring and enforcement effort, and lead to increased tax revenues.

Truly, the potential benefits are immense. If we can eliminate only five percent of the problem, the State could realize a \$100 million increase in its income tax revenues alone. Additional benefits from reduced unemployment insurance claims and other nonquantifiable savings would further increase this total substantially.

Respectfully submitted,



MICHAEL KASSAN, Chairman  
Blue Ribbon Study Advisory  
Committee on the Underground  
Economy



NATHAN SHAPELL, Chairman  
James M. Bouskos, Vice Chairman  
Senator Alfred E. Alquist  
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A REVIEW OF SELECTED TAXING AND  
ENFORCING AGENCIES' PROGRAMS  
TO CONTROL THE UNDERGROUND ECONOMY

EXECUTIVE SUMMARY

In response to a request by Governor George Deukmejian, the Commission on California State Government Organization and Economy, also known as the Little Hoover Commission, initiated a comprehensive study of the underground economy with emphasis on cash-pay transactions. Because of the widespread impact of the underground economy on State operations, the Commission expanded the scope of this study to include other enforcement problems created by the underground economy.

The underground economy consists of all illegal and many legal transactions which have not been adequately reported. Estimates of the underground economy nationwide range from \$300 to \$600 billion each year, with approximately two-thirds of this consisting of legal transactions. In California, experts estimate that the underground economy exceeds \$30 billion annually, accounting for almost \$2 billion in unpaid income tax alone.

"Cash-pay," as used in this report, is the practice of paying in cash, check, barter or other means without adequately recording and reporting that payment to the appropriate taxing authorities. A comprehensive example of this type of activity is a construction contractor who receives cash from an individual for certain repairs to the individual's house. The contractor then pays his or her employees in cash without withholding taxes, or pays cash "under the table" for materials without paying sales tax on them. Because no income records exist, neither the contractor nor the employees pay income tax on their earnings. The contractor also fails to provide worker's compensation insurance for his or her employees. Finally, the contractor who violates all of these tax and labor laws may also be operating without a license issued by the Contractor's State License Board.

During this study, we reviewed the activities of five State agencies: (1) The Department of Industrial Relations, which is responsible for protecting the workforce; (2) the Employment Development Department, which has various responsibilities for employee planning, placement and training, as well as for collecting employment and withheld State income taxes and paying unemployment insurance benefits; (3) the Franchise Tax Board, which administers the personal income tax and the bank and corporation tax laws; (4) the Board of Equalization, which administers a number of programs including the sales and use tax; and (5) the Contractors' State License Board, which tests, licenses and regulates contractors.

Chapter I and Appendix A of this report provide a detailed discussion of the underground economy and a discussion of the responsibilities each of the above State agencies has in relationship to it. Chapters II through VI present the Commission's findings regarding the State's efforts to control the underground economy, and Chapter VII presents the Commission's recommendations for more effectively dealing with this problem.

#### SUMMARY BY CHAPTER OF FINDINGS AND RECOMMENDATIONS

##### CHAPTER II: STATE AGENCIES ARE NOT ADEQUATELY ENCOURAGING VOLUNTARY COMPLIANCE WITH THE STATE'S TAX SYSTEM

America's system of taxation is based on voluntary compliance and self-assessment. This means that people are expected to accurately calculate and pay their own taxes. While most individuals do just that, there is need for enforcement activities to catch and correct those who either innocently erred or intentionally misstated their tax liability.

Finding #1. The level of voluntary compliance in paying State taxes appears to be declining. Although it is difficult to measure voluntary compliance, it is generally acknowledged that the level of voluntary compliance is going down. While the State has not conducted any comprehensive study to measure voluntary compliance, the Internal Revenue Service has conducted various studies which indicate that the level of voluntary compliance with federal income tax laws is declining. In addition, tax audits are becoming more productive, which may indicate a reduction in correct self-assessment.

Finding #2. There are no centralized sources of information to aid businesses who desire to voluntarily comply. To register with all applicable State agencies and obtain all information needed to comply with State laws, a taxpayer may have to go to several locations. The Department of Commerce is establishing a small number of Small Business Development Centers which will provide referrals to other State agencies. However, instead of establishing numerous new centers, existing State agencies could cooperate in providing information to taxpayers on all State requirements.

Finding #3. The value of enforcement in encouraging voluntary compliance has not been adequately recognized. The enforcement staff of most of the agencies we studied are normally evaluated based on the number of cases completed and the amount of funds they recover. They do not normally consider the effect of their actions on voluntary compliance because these benefits are difficult to measure. However, in the long run, these effects may be the most important.

Finding #4. Taxing and enforcement agencies have not taken full advantage of the value of publicity in obtaining additional voluntary compliance. Although publicity on enforcement activities will likely result in additional voluntary compliance, most of the agencies we studied have been quite limited in their use of publicity. Although agencies appropriately give high priority to closing cases and recovering funds, equal priority must be given to increasing public awareness of taxpayer responsibilities and the severe consequences of not complying with the law.

### CHAPTER III: INFORMATION SHARING SHOULD BE EXPANDED AND IMPROVED

Many State agencies have information on businesses, much of which can be shared among agencies where such agreements exist. When an agency cites a business for violation of a State law or regulation, other agencies may be able to identify other violations and issue additional citations when and if they find out about the initial violation. This sharing of information and the subsequent enforcement of additional laws would improve the State's overall effectiveness in identifying and eliminating participants in the underground economy as well as increasing overall voluntary compliance.

Finding #1. Currently available State information is not adequately shared between agencies. Because of access problems, internal agency concerns, and staffing problems, information is not shared between agencies as often as it could be. Enormous amounts of information is shared on a routine basis, but information on enforcement activities has not been shared as well as possible. Reasons for not sharing this information include privacy concerns, an agency's desire to protect its own cases, and confusion about sharing data. Because this information is not shared, the State loses revenue and additional opportunities to combat the underground economy.

Finding #2. Information which is shared with other agencies is not always used by the receiving agency. This information is not being used because of the timing of enforcement actions and due to staffing constraints. In not using this information, the State agencies are not maximizing revenue or the opportunity to influence taxpayer compliance.

Finding #3. The quality and format of shared data significantly limits its use. Some leads are not used because of the quality or the format of the data. Quality problems come about because the agency generating the lead may not be fully aware of the needs of the other agency. Therefore the lead may contain too little information for the receiving agency to properly evaluate it. Format problems also are often due to the lack of a common identifier number for State use.

Finding #4. State agencies are not actively identifying and using new sources of information. State agencies have agreements to share information and in fact are sharing enormous amounts of data. However, we found that State agencies could devote more resources to obtaining and using new information for combatting the underground economy. Other State agencies and particularly local government have data which could effectively identify potential violators.

CHAPTER IV: LIMITED AUDIT STAFF  
REDUCE POTENTIAL RECOVERIES AND  
OVERALL TAX COMPLIANCE

All audit and investigative agencies cite high-tech information sharing as the wave of the future. While we agree that much more can and should be done in this area, staffing shortages should not be tolerated until high-tech methods are established. While we do not believe that additional staff will solve every problem, we do feel that adequate staffing is one aspect of a balanced program of enforcement, particularly since auditors generate revenues far in excess of their cost.

Finding #1. Although audits are cost effective, auditor staffing in some agencies has decreased. While the underground economy is increasing, the number of auditors and enforcement staff has remained relatively level or actually decreased in some agencies. Although the basis of taxation is self-assessment and voluntary compliance, this concept must be reinforced with an effective enforcement program to dissuade potential tax evaders.

During the four years from 1980 to 1984, the audit staff at the EDD was reduced by 18 percent while the number of registered employers increased by 14 percent. The B of E audit staff was reduced by one percent during that same period while the number of resale licenses in force increased by 12 percent.

There is a need for a certain amount of field personnel to conduct a certain number of audits, provide "field presence," and follow-up on leads provided by other agencies through tips, other external sources, and high-tech data matches.

Finding #2. Collections backlogs have more than doubled in four years. The collective outstanding receivables balance for the B of E, the EDD, and the FTB in 1980 was \$492 million. In 1984 the balance exceeded \$1 billion. Once again, a small investment in resources will result in significant returns for the State.

CHAPTER V: ENFORCEMENT MECHANISMS  
AND STATUTES NEED REFORM

Audit selection criteria, audit methods, enforcement and penalties used by the State agencies do not adequately address

the problem of the underground economy. While the impact of these activities on the underground economy is difficult to measure, it must be considered.

Finding #1. Agencies' audit selection criteria do not adequately consider the underground economy or the value of increasing voluntary compliance. The B of E and the FTB have been mandated by the Legislature to maximize revenues while the CSLB has been directed to mediate consumer and industry complaints and investigate a three percent sample of new applicants. Similarly, the EDD tax branch must give priority to obstructed claims for unemployment insurance benefits. As a consequence of these mandates, none of these entities is able to direct a significant amount of resources towards combatting the underground economy.

Finding #2. DIR deputies have not been adequately trained in methods to quantify the extent of underground economy activity. Although there are accepted techniques available to reconstruct how extensive certain past cash-pay violations were, DIR deputies tend to cite violators only for the current period or for those periods for which an employee or a past employee is willing to testify about. This occurs primarily because DIR's Labor Standards and Enforcement Division employs very few auditors, and staff in general are not trained in audit reconstruction methods.

Finding #3. State agencies are not sufficiently pursuing criminal penalties which would increase deterrence. There are various penalties available to use against tax evaders ranging from small penalties to loss of professional licenses and resale permits to incarceration. We found that agencies normally settle for minor penalties, even on blatant cases, rather than taking the time and effort to pursue criminal sanctions. Without taking a case to court, the information is normally confidential and therefore cannot be used for publicity. The general unwillingness to pursue criminal sanctions is due to the need for greater management direction and priority, and due to district attorneys' unwillingness to prosecute such cases.

Finding #4. State agencies are not using cross-agency penalties which would provide maximum deterrence and recoveries. Cross-agency penalties are available in many cases where a taxpayer violated a tax or employment law. For example, a taxpayer violating cash-pay laws may be cited or penalized by the EDD, the DIR, the FTB and the CSLB. However, because citation information is not always shared or because other cross-agency provisions are not being fully used, the State is not maximizing its enforcement tools, deterrence, and recoveries.

Finding #5. There are few penalties for repeat offenders and the need for appropriate follow-up audits of violators. Blatant or repeat offenders should be penalized at a higher

level than taxpayers making an "honest mistake." However, current regulations seldom allow significantly higher penalties for repeat offenders. Further, there are few provisions for follow-up inspections. Therefore, a taxpayer can continuously gamble on not getting caught, or, if caught, on paying a relatively minor penalty.

Finding #6. Enforcement against employees involved in cash-pay is inadequate. Cash-pay violations often are the result of collusion between the employer and employee. However, after the violation has been discovered, follow-up action is inadequate to ensure that the employee has reported the income on his or her income tax return and that he or she has not been inappropriately receiving unemployment or other benefits.

Finding #7. Penalties for not carrying worker's compensation insurance are inadequate. Unemployment Insurance and Worker's Compensation Insurance are two separate programs designed to protect employees. While failure to provide Worker's Compensation Insurance is normally considered a much more serious problem than failing to provide Unemployment Insurance, the penalty is significantly less.

Finding #8. There is continuing controversy over the definition of an independent contractor verses an employee. In many cash-pay instances there are difficulties in determining whether there is an employer/employee relationship or an independent contractor relationship. Different states have different criteria and the federal congress has been attempting to solve this problem. Until either the State or Federal government provides greater direction, many individuals will be able to continue abusing the tax system.

#### CHAPTER VI: REORGANIZATION COULD INCREASE EFFICIENCY AND LEAD TO GREATER RECOVERIES AND DETERRENCE

The State's major taxes are administered by three agencies, the B of E, the EDD, and the FTB. This fragmented organization causes coordination problems and certain levels of duplication. While this type of separation of responsibilities may be the most appropriate organization for this State, several past studies have recommended restructuring or consolidating these activities. Although we did not conduct a detailed analysis of the advantages and disadvantages of reorganization, this study has pointed out a number of problems created in part by the separation of these activities.

Finding #1. Lack of a single revenue agency results in duplication. Each taxing agency, including the EDD's Tax Branch, has evolved based on its individual needs. Thus the existing monitoring and management information systems appear quite different. However, there are many systems and activities which are duplicative including billing delinquent taxpayers,

issuing warrants and letters, and finally attaching wages or placing liens on property. Similarly, each agency maintains its own computerized data base files which contain certain duplicative data.

Finding #2. Because the State's revenue and enforcement agencies are separate, they have not worked together on task forces to combine efforts on blatant cheaters. If one agency catches a tax evader, it may not be able to fully punish that taxpayer due to lack of information, insufficient sanctions, or staffing constraints. Other State agencies may be able to contribute to the enforcement of these cases, but the agencies have not combined efforts to form task forces. Such an approach would, through the combined expertise of the participants, result in the levying of maximum penalties and offer the opportunity for heightened publicity, thereby generating increased deterrence.

Finding #3. Separate audit staffs preclude use of the "single audit" concept which may result in misdirected audit work. Because each agency's audit staff is concerned only with one type of tax, there is duplication in auditing. Further, taxpayers are audited for one tax, but the auditor does not address other State taxes. This is the opposite of the "single audit" concept used by private industry and the federal government. Under this concept, one auditor or team of auditors conducts a review of the auditee's compliance with all applicable laws and/or other criteria.

Finding #4. Conflicting or dissimilar objectives limit the overall effectiveness of State enforcement activities. Since each agency is most concerned with its own objectives and collecting its own revenue, the overall benefit to the State is often overlooked. Because of this, the State's overall effectiveness in combatting the underground economy may be limited. Specifically, information may not be shared, audits are not coordinated between agencies, task forces are not used, and overall fines and sanctions are not maximized.

## CHAPTER VII: RECOMMENDATIONS

The underground economy costs the State of California billions of dollars each year. Although it can probably never be eliminated, a small percentage of reduction can mean hundreds of millions of dollars in increased revenues for additional State services or to reduce the liability of the honest taxpayer. These revenues will be realized both directly through additional taxes, penalties and interest, and indirectly through increased voluntary compliance.

Following is a summary of our major recommendations (we encourage the reader to review Chapter VII in detail for a complete listing and understanding of the recommendations).

1. The Governor and Legislature should consider reorganizing some or all State taxation responsibilities. The final determination on whether or not to reorganize, and if so, the level of reorganization necessary should be based upon the results of an in-depth study of all responsibilities of existing State tax agencies conducted by a team of specialists with expertise in taxation, banking, management, computer systems, and other appropriate disciplines.

2. The Legislature and Governor should, through statute or executive order, establish a Multi-Agency Task Force to conduct complete audits and investigations of blatant tax violations and cash-pay transactions. This task force should consist of representatives from the FTB, the B of E, the EDD, the CSLB, the DIR, the Attorney General's Office, and district attorneys.

3. The Governor and the Legislature should require representatives from the EDD, the FTB, the B of E, the DIR, the CSLB, and other appropriate State agencies to form a standing committee to continuously study opportunities for sharing information, improving formats for the information, and eliminating access obstacles. This committee should also include representatives from the federal government, local governments, other states and nongovernmental entities, as appropriate.

4. The Legislature and the Governor should require all State agencies to use a common identification number or a system of cross-reference numbers for all businesses.

5. The Governor and the Legislature should provide ways for nontaxing agencies to obtain and use greater amounts of information currently available only to tax agencies.

6. On a test basis, auditors and investigators from the State's taxing and enforcement agencies should be trained on the basic requirements of other agencies and, where appropriate, be given authority to enforce the other agencies' laws. When conducting an audit, they should conduct minimum tests of compliance with other agencies' requirements. If the test is successful, this should be expanded to all auditors and investigators.

7. The Department of Industrial Relations should review the need to increase the number of audit staff employed in the Labor Standards Enforcement Division to enable it to conduct more thorough audits of cash-pay violations. Additionally, division staff should receive training in "reconstruction" methods of auditing.

8. The Governor and Legislature should reevaluate the staffing levels needed by audit, investigative, and enforcement units.

9. The Board of Equalization, Department of Industrial Relations, Employment Development Department, and Contractors' State Licensing Board should increase their level of prosecutions and each should develop an expanded program to actively publicize cases in which violators have been successfully prosecuted. The use of the media should also include an expanded public education program.

10. The Governor and the Legislature should encourage the U.S. Congress to create guidelines for determining whether an individual is acting as an employee or as an independent contractor.

11. The Governor and the Legislature should authorize a "graduated" penalty system where appropriate to provide more severe penalties for repeat violators.

12. State agencies should develop a system of selective "follow-up" visits to insure that previous violators are still in compliance with the law.

13. State tax and enforcement agencies should consider expanded use of automatic computer-generated citations based upon work done by other agencies.

14. The EDD, the DIR, and the FTB should initiate a trial project to determine the extent of loss to the State because of employees receiving cash-pay who are also receiving unemployment insurance and/or are not paying income tax on their cash-pay income. Based on the results of this trial project, the three agencies should consider additional enforcement in this area.

15. The Legislature and Governor should increase the penalties for employers who do not carry workers' compensation insurance.

16. The State should increase the proportion of cases developed for criminal prosecution and work closely with district and city attorneys to ensure that these cases are prosecuted.

## CHAPTER I

### INTRODUCTION

The Commission on California State Government, Organization and Economy, also known as the Little Hoover Commission, was established in 1962 to review the management of State activities and recommend ways for the State to operate more efficiently and effectively. Throughout its history, the Commission has conducted numerous studies of the State's taxing and regulatory agencies with the objective of recommending improvements in management, organization and operations.

In July 1984, Governor George Deukmejian requested that the Commission undertake a study of the Underground Economy with emphasis on cash-pay transactions. As discussed in this report, "cash-pay" is the practice of paying a worker in cash, check, or by other means without reporting the transaction to the appropriate taxing and/or regulating authorities. This activity is found in many industries, but is especially common in those industries which have a mobile labor force and/or deal heavily in cash. Examples most often cited include construction, restaurants, bars, and the garment industry.

In requesting this study, Governor Deukmejian requested that the Commission, as part of its study, attempt to identify:

- (1) Ways in which inter- and intra-governmental cooperation can facilitate and expand the exchange of information, thereby facilitating the identification of violators;
- (2) Existing audit capabilities that could be expanded and improved;
- (3) The deterrent effect of existing sanctions and the need for additional sanctions;
- (4) The need for legislation to broaden the scope of authority or to reorganize existing resources.

Because of the magnitude of the underground economy and because it affects so many State agencies, the Commission expanded the scope of this study to consider not only cash-pay, but also to consider other elements of the underground economy where tax evasion occurs, how to identify it, and effectively enforce the law.

### BACKGROUND

The existence of an underground economy has been an accepted fact since taxation began. However, it was not until 1977, when Peter Gutmann wrote an article entitled "The Subterranean Economy" and estimated the underground economy at

over ten percent of the gross national product, that serious public attention was focused on this problem.

In its broadest definition, the underground economy consists of all illegal plus many legal transactions. About one-third of these deal with the more "classic" criminal activities such as drugs and prostitution. The other two-thirds, estimated between \$200 and \$400 billion each year, consist of legal activities which are not reported to the tax collector. In California, the underground economy is estimated to range from \$30 and \$45 billion resulting in lost State income taxes alone of almost \$2 billion. In this study, we are focusing only on noncriminal activities.

A 1982 Harris Poll found that 30 percent of all households in this country have members working in the underground economy. A 1984 study conducted for the Internal Revenue Service further found that one in five people polled admitted cheating on their federal income tax return. The perception that the problem is widespread may be extremely dangerous, because more people may be tempted to join the underground economy if they believe that everyone else is involved in it.

In addition to the direct loss of tax revenues, the underground economy adversely affects the State in several other ways. First, since the worker's income is not recorded, the participants in the underground economy frequently apply for unemployment insurance, thereby providing them with a second tax-free income. These same individuals may also inappropriately receive health care under the Medi-Cal program. Second, honest businesses and workers are at a competitive disadvantage and may even feel compelled to join the underground economy. Third, unlicensed businesses, such as contractors, may not be qualified to do the work for which they are contracting. The contractor may be providing an unsafe working environment and may not be adequately protecting his or her employees by providing disability insurance, unemployment insurance, and/or workers' compensation insurance. Finally, all law-abiding citizens are hurt in that their share of the tax burden is higher than it would otherwise be if these tax cheaters paid their fair share.

#### "Cash-Pay" Transactions

When an employer pays an employee in cash (or by check, barter or any other means) and does not report the payment to the taxing authorities, he has engaged in "cash-pay" transactions. A classic example can be found in parts of the construction industry when a contractor pays his or her employees in cash from the back of his or her pickup truck. More subtle examples include a grocery store clerk who receives food instead of wages for overtime, and a doctor who trades services with an attorney. Another variety of cash-pay is the worker who is on the books for a certain number of hours, then

goes off the books. This method allows the worker to qualify for unemployment insurance or union benefits. Once qualified, the worker is willing to accept lower wages in cash, thus benefitting both the employer and the worker.

The ramifications of the "cash-pay" transaction are illustrated through an example of an imaginary contractor who uses cash-pay. First, the contractor was awarded the contract because of his or her low bid. This low bid was made possible because of the reduced expenses when cash-pay is utilized. Thus, he or she hurt the honest contractors and their employees who would have reported and paid taxes on their income. Secondly, the contractor hurts the State (and federal government) since he or she does not pay his or her share of payroll taxes. Thirdly, the employees fail to pay their share of payroll taxes and their income tax. Fourthly, these employees may be claiming unemployment or other benefits such as welfare and Medi-Cal to which they are not entitled. Finally, the employees themselves are at risk because they may not understand their rights to worker's compensation insurance, unemployment insurance, disability insurance, or social security.

#### Sales Tax Evasion in the Underground Economy

Another major segment of the underground economy, underreporting sales, directly impacts the State's collection of sales and use taxes, as well as income tax. A gas station operator, for example, might buy three tanker truck loads of gas from his or her main supplier each month, and one load from any one of several independent suppliers (paying cash). The operator will then report only three-fourths of his or her income for both sales and use tax and income tax purposes. This same method can be used by virtually any retailer and is extremely difficult to detect without a tip.

#### State Agencies Considered in this Study

Several agencies in California have various responsibilities in this area. The key organizations that we are reviewing and working with include the Department of Industrial Relations, because of its role in protecting the relationship between employer and employee, two State taxing agencies--the Franchise Tax Board and the Board of Equalization, the Employment Development Department which provides employment related services and also collects payroll taxes, and the Contractors' State License Board because of the prevalence of the underground economy in the construction industry.

The Department of Industrial Relations (DIR) is responsible for protecting the work force, improving working conditions, and advancing opportunities for profitable employment. Within this broad range of responsibilities, DIR enforces the labor code

through investigations, citations, hearings and criminal prosecutions.

The Franchise Tax Board (FTB) administers the personal income tax and the bank and corporation tax laws, along with several smaller programs. While it is responsible for over \$12.5 billion of State revenue, about 80 percent of these funds are actually collected by the EDD. The FTB's filing enforcement program was responsible for tax charges totalling \$222 million for fiscal year 1983-84 at a cost of about \$6 million while its audit activities resulted in net assessments of \$535 million at a cost of \$32 million.

The Board of Equalization (B of E) administers 13 programs; the largest of which is the sales and use tax program. This tax is imposed on retailers for the privilege of selling tangible personal property in California. This tax may be passed on to the consumer and almost always is. For fiscal year 1983-84, the B of E collected \$10.9 billion, of which \$8.8 billion was sales and use tax.

The Employment Development Department (EDD) is both a service entity and a taxing agency. Its objectives include person-power planning, training, employee placement, and processing unemployment and disability insurance payments, as well as collecting employer and employee contributions to unemployment insurance, disability insurance, and, as mentioned above, collecting withheld State income tax. For fiscal year 1984-85 the EDD collected a total of \$11 billion in the above mentioned taxes.

The Contractors' State License Board (CSLB) is responsible for licensing and regulating contractors within California. The CSLB has no direct tax or employer-employee responsibilities, although it can discipline licensees for violating labor laws. We are including the CSLB in our study because the construction industry is known for making extensive use of cash-pay. The conclusions and recommendations we make in this report may also be applicable to other California regulatory boards and bureaus, some of which may issue licenses. Detailed information on these agencies can be found in Appendix A.

#### The California Tax Amnesty Program

AB 3230 of 1984 (Chapter 1490, Statutes of 1984) required the FTB and the B of E to develop and administer a one-time tax penalty amnesty program. This program allowed individuals who understated their personal income tax or sales and use tax liabilities an opportunity to pay the past due taxes (with interest), but without having to pay penalties or fear criminal prosecution. With the end of the amnesty period, the FTB has several new enforcement measures available to it, including additional taxpayer reporting requirements, collection tools (such as continuous levies), and rewards for tips.

In addition, three new provisions became effective to discourage unreported cash payments: (1) this practice was made a misdemeanor with a maximum penalty of \$1,000 or imprisonment for any employer, employee or other person who participates in a scheme to pay wages without proper accounting for deductions; (2) licensing boards have new disciplinary powers against employers who pay in cash and fail to keep adequate records. The licensee may also be liable for actual investigative costs up to \$2,500; and (3) the FTB may assess a civil penalty of up to eleven percent against a payor who fails to report the payments, and, in addition, the payor will not be allowed a deduction for income tax purposes for the payments.

The new statutes also require the FTB to develop and maintain a system to allow cross-referencing of information between the State's major revenue producing agencies. Currently, most agencies use their own unique taxpayer identification number. For example, the FTB uses social security numbers while the B of E assigns a Board of Equalization Identification Number (BEIN). The cross-referencing system will require that all State tax information be in a format that will allow high-tech computer cross-matching of records for enforcement and collection purposes.

#### SCOPE AND METHODOLOGY FOR THIS STUDY

As discussed above, the main focus of this study was the practice of cash-pay. However, in addition to cash-pay we included other employer-employee considerations in our study, such as the practice of inappropriately categorizing employees as independent contractors to avoid payroll taxes. We also considered other effects of the underground economy on taxing authorities such as the Franchise Tax Board and the Board of Equalization.

Because of the complexity of the various tax laws and employer regulations, the Commission appointed a Blue Ribbon Advisory Committee to provide input and oversight to this study. The Committee consisted of the Chairmen of the Senate Committee on Industrial Relations and the Assembly Committee on Labor and Employment, representatives from the various State taxing and regulatory agencies, the U.S. Internal Revenue Service, management and employer organizations, employee and union organizations, labor and tax attorneys, and a partner in a Big-Eight accounting firm. Appendix B contains a complete list of Committee members. The Committee met formally three times during the study, and members provided additional input at various times as needed. While all input was considered, it must be remembered that this is a report of the Commission and the findings and conclusions contained herein do not necessarily reflect those of all members of the Advisory Committee.

At the beginning of this study, the Commission held a public hearing to obtain background information on this subject and to obtain information from members of the public. In total, this study required over six months of intensive field review of the activities of the above mentioned State agencies.

Although voluntary compliance is difficult to measure, there are strong indications and widespread belief that the level of voluntary compliance is declining. For example, the IRS estimated that its tax gap (taxes which should be paid but are not) has grown from \$28.8 billion in 1973 to \$81.5 billion in 1981 (This is based on approximately \$290 billion of unreported income). The largest component of this gap, more than \$52 billion, resulted from taxpayers who failed to report their full income.

As additional evidence, the IRS points to a recent opinion survey which found that (1) the public views tax cheating as less serious than other crimes; (2) people are unlikely to inform on a tax cheater; (3) people feel that there is little or no chance that their return will be audited; and (4) the public believes that more people cheat now than did in the past. Furthermore, many news and magazine articles have discussed the growth of the underground economy. These articles often refer back to the Peter Gutmann research and cite IRS statistics, local examples of the underground economy, other nations' experiences, and the impact of organized crime.

In addition, tax audits are becoming more productive, indicating that there is a lessening in the level of voluntary compliance. For example, the B of E, the FTB, and the EDD have all found that the tax liability change per hour of audit effort has grown over the last five years, as shown below.

TAX LIABILITY CHANGE PER AUDIT HOUR

FY	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
FTB	\$163	\$205	\$242	\$262	\$256
B of E	\$139	\$157	\$171	\$205	\$237
EDD	\$135	\$107	\$119	\$178	\$251

(Note: these amounts are for the fiscal year ending June 30. Amounts are rounded to the nearest dollar. Some of these changes may be due to inflation changes in audit coverage and/or changes in audit selection techniques.)

FINDING #2. THERE ARE NO CENTRALIZED SOURCES OF INFORMATION TO AID BUSINESSES WHO DESIRE TO VOLUNTARILY COMPLY.

As can be seen in the table, tax liability change per audit hour has increased significantly over the last four years. The percentage increase ranged from 57 percent for the FTB to 70 percent for the B of E to 86 percent for the EDD. These large increases add credence to the belief that more individuals are misstating their taxes each year, and that the agencies are improving their audit selection processes.

The taxing systems, as well as the underground economy, are so large and complex that it is impossible to identify all

violators and enforce all laws. As previously stated, taxing agencies must therefore rely upon and encourage voluntary compliance. California tax and regulatory agencies are doing many things to encourage voluntary compliance, including providing assistance and education, and taking disciplinary action. However, more can be done.

Assistance in understanding and preparing tax forms is available to all taxpayers through various sources. All registration and tax forms come with instructions, and taxpayers may phone or visit State offices to receive help. The FTB sends tax forms to all individuals who filed tax returns in the previous year. The booklet transmitting these forms includes instructions as well as highlights of changes for the year.

Both the EDD and the B of E send forms to registered businesses, usually on a quarterly basis. Included with the tax forms are newsletters providing information to the taxpayer on changes in laws, new interpretations, and other information. The CSLB also sends a quarterly newsletter to all licensed contractors.

The State could provide additional assistance by establishing centralized sources of information to help small businesses comply with the variety of laws, rules and regulations which govern them. In many areas the taxing and regulating agencies are not co-located. When a business registers with the B of E, the Board will also register the business with the EDD if the business has employees. However, the EDD does not register a business with the B of E because of the sales tax bonding requirements. Further, several types of employers must register with the DIR, such as farm labor contractors, garment contractors, talent agencies, and athletic agents. The DIR does not register these employers with the EDD or check to determine if they have already been registered. In most instances, field offices do not stock the basic forms used by other agencies.

The State Department of Commerce is currently establishing several Small Business Development Centers. These centers will not be providing information on all tax and reporting requirements, but instead they will refer small businesses to the appropriate State agencies. Further, the concept of these centers is relatively new, and at this time there are only three centers in operation. Short of establishing numerous centers around the State, greater cooperation among the offices already providing information to the public would likely result in greater compliance.

**FINDING #3. THE VALUE OF ENFORCEMENT IN ENCOURAGING VOLUNTARY COMPLIANCE HAS NOT BEEN ADEQUATELY RECOGNIZED.**

Voluntary compliance is affected by the enforcement activities of each agency. These enforcement activities often

result in penalties ranging from small fines to incarceration. However, enforcement activities have two benefits--the recovery of taxes and/or penalties, and increasing voluntary compliance. The first benefit can be directly measured, and is often the basis for decision making. The second benefit cannot be directly measured, and so it is often given little or no consideration in decision making. For example, auditors are generally evaluated based on direct recoveries and cases closed. We found that only the FTB considers the number of cases taken to prosecution when evaluating its employees. The FTB began encouraging employees to select and develop cases for prosecution in 1981 and provides special recognition for this activity to compensate for the fact that it takes much longer to develop these cases than to complete other cases. The FTB's objective is to realize additional voluntary compliance through publicity, rather than simply recover direct taxes due.

If an audited individual complies with the laws and regulations for several years after the audit, the State realizes a direct benefit. However, this benefit is not measured. Likewise, if he or she influences friends or co-workers to comply, additional unmeasured benefits accrue. Finally, as cases are taken to court and are publicized, more individuals may decide to comply voluntarily rather than take the chance that they might get caught. Thus, there may be a long series of unmeasured benefits of a properly handled case. (Because tax information is generally confidential, taxing agencies can usually only get publicity on a case if that case goes to court.)

As stated above, no enforcement system can catch and punish all cheaters. While voluntary compliance is encouraged by the aforementioned activities, much more can be done. In the following chapters we discuss several areas where improvements can be made in enforcement and in encouraging voluntary compliance, including greater sharing of information, greater use of shared information, better staffing, additional enforcement statutes and mechanisms, and changes in organization.

**FINDING #4. TAXING AND ENFORCEMENT AGENCIES HAVE NOT TAKEN FULL ADVANTAGE OF THE VALUE OF PUBLICITY IN OBTAINING ADDITIONAL VOLUNTARY COMPLIANCE.**

One of the reasons often cited for the decline in the level of voluntary compliance is the belief that since "everyone else cheats, so should I." Additional publicity about how cheaters are caught and punished could change this trend.

The publicity which accompanied the Tax Amnesty Program was extremely valuable because it informed people of the amnesty aspects of the program but, at the same time, warned them of the heightened enforcement activities which would follow the amnesty period. Similarly, the publicity which surrounded the EDD's

Investigation Division's Underground Economy Detection Program's activities resulted in several hundred additional leads. This publicity may have significant impact on deterring other individuals from joining the underground economy.

While the FTB has made extensive use of publicity, the B of E, the EDD, the CSLB and the DIR have done little to capitalize on the value of publicity in obtaining additional voluntary compliance. For example, the EDD only issued five press releases regarding underground economy activities in 1984. One reason for this is that privacy considerations sometimes preclude release of individual names. This constraint does not, however, preclude agencies from releasing summary data on the frequency of error detection or citations.

## CHAPTER III

### INFORMATION SHARING SHOULD BE EXPANDED AND IMPROVED

Enforcement against individuals operating in the underground economy is difficult. Because the underground economy is made up of many individual transactions, most of which are for small dollar amounts, enforcement agencies cannot reasonably expect to catch all participants. As stated above, there are various State agencies working in this area, but because of problems related to access to information, timing of investigations, each agency's own parochial interests, and staffing, they are not always able to handle their own workload, much less worry about sharing information with other agencies or working on leads furnished by these other agencies. Thus, information is not shared as frequently as it should be, and, when shared, is not always used.

### CURRENT AGREEMENTS TO SHARE INFORMATION

Certain State agencies have policies which allow the general sharing of information. There are certain limitations, but much information can be shared, particularly among taxing agencies. For example, the EDD Administrative Manual lists 8 federal agencies, 23 State agencies, 8 types of local entities, other states, and various other entities which can receive EDD information. This manual specifies the type of information which can be shared and under what conditions it can be shared. Each of the other State agencies has similar guidelines for sharing information. In addition, there are agreements between entities to share specific information. The FTB, for example, has agreements to share large amounts of data with the IRS. Similarly, the EDD and the FTB have an agreement to share employment information available to each of them.

When large amounts of data are available in formats that allow for computerized matching, tax agencies can realize significant returns for relatively little effort. For example, the FTB, in conjunction with the I.R.S., can match the interest income reported on computer tape by banks with that reported by individuals on their tax returns. The FTB can then automatically generate an assessment if the taxpayer underreported. This so-called "high-tech" means of comparing and verifying data is highly cost-beneficial, and requires minimal staff time.

### The Interagency Contractor Enforcement Agreement

In 1978, three State agencies developed an agreement for sharing information in an attempt to concentrate efforts against the underground economy in the construction industry. The State agencies--the EDD, the CSLB, and the DIR--formed the Interagency Contractor Enforcement agreement, commonly known as the "ICE" agreement. Under this agreement, each agency is

required to routinely provide certain data on contractors to other agencies, and to provide additional information on a request basis. For example, if a Deputy Labor Commissioner cites a contractor for violating cash-pay laws, the Labor Commissioner's Office should send the contractor's name to the CSLB for them to consider disciplinary action. Similarly, when the CSLB deputies obtain information on unlicensed contractors with employees, they are supposed to notify both the DIR and the EDD. The agency that receives the information may use it to open an investigation to determine whether the employer violated any other laws.

In addition to the information available to agencies through the ICE agreement, there is a wealth of other information available within the State. If a business wishes to buy inventory at wholesale and avoid paying sales tax on the purchase, it must obtain a resale permit from the B of E. If a business has employees, it is required to register with the EDD. If a business is in the construction field, it must have a license from the CSLB. Thus, many businesses are registered at least once and often more than once with the State. Further, because of city, county, and federal license and permit requirements, these same businesses may also be registered with other governmental agencies. In addition to registering businesses, agencies often have other data on the business. For example, the FTB and the B of E receive financial information from the business. The EDD receives information on employees. The CSLB, the Secretary of State, and other regulatory agencies receive information on the business's organization.

If a business is cited by one of the taxing or regulating agencies for inappropriate or illegal activities, there is a high probability that other agencies also have grounds for a citation. For example, if an unlicensed contractor has employees and pays inappropriately in cash, the CSLB can cite him or her for operating without a license, and both the EDD and the DIR can cite for cash-pay violations. Unfortunately, the information available in one agency is not always shared with, or used by, other agencies.

FINDING #1. CURRENTLY AVAILABLE STATE INFORMATION IS NOT ADEQUATELY SHARED BETWEEN AGENCIES.

Although State agencies are sharing information cooperatively, we found that information is not being shared to the greatest extent possible. Although there are some technical and legal constraints to sharing information, much information which could be shared under existing regulations and agreements is not being shared. For example, the EDD routinely provides enormous amounts of employee information reported by employers to the FTB and to the IRS. However, prior to our study the EDD had not provided any leads under the ICE agreement to either the CSLB or the DIR for several years due to funding

restrictions. Similarly, we found that sharing between the FTB and the B of E was very limited.

There are several reasons why this information is not being shared. These reasons can be separated into three main categories--access, agency parochialism, and other constraints.

#### Constraints to Access to Information

Because of certain federal and State privacy laws, nontaxing agencies are not allowed to receive and/or use certain tax-related information. For example, the DIR is the lead agency in the ICE agreement, but neither the DIR nor the CSLB can use certain EDD information unless they are enforcing the unemployment insurance code. In working on ICE leads, deputies from the DIR and the CSLB have found that it is often difficult to get information from the EDD, and thus they will often not follow-up on leads from the EDD. Further, because of restrictions on access to information it is difficult for nontaxing agencies to participate in high-tech information sharing.

#### Individual Agency Interests Limit Information Sharing

Each agency is understandably concerned about recovering its money (taxes and penalties) and/or completing its own cases. Thus, agencies are hesitant to share information on an individual if they are concerned that other agencies might also claim funds or even take disciplinary action which could put the taxpayer out of business or jeopardize his or her ability to pay.

While the B of E has been sharing some information, we believe they can become involved to a much greater extent. B of E officials told us that they already have much information and without additional staff they cannot benefit from more information. However, they have no way of assuring that they are using the best information available, or that they have all information to make the best decisions on where to place their audit resources.

For example, the FTB has information available on every individual who reported self-employment income on his or her income tax return. This information is reported to the FTB on schedule C of the tax return. This schedule also shows the type of business the individual conducts. Thus, the B of E could use this information to locate all individuals who reported retail sales on their income tax returns but either did not file sales tax returns or reported different amounts. There may also be merit in the B of E using data available at the EDD. For example, by using industry profiles the B of E could estimate a taxable sales range for a business in a given industry with a certain number of employees. If the number of employees reported to the EDD indicated a sales level higher than was

reported to the B of E, the B of E may wish to initiate an audit.

#### Other Constraints to Information Sharing

There are several other reasons given for not following-up on leads. Some State agency officials told us that they thought that the ICE agreement had expired several years ago. Thus, they never generated any leads, and since leads were not forthcoming from other organizations they had no reason to think that the program was still in operation. Others were concerned that ICE did not provide enough privacy security.

There is also a certain amount of confusion regarding policies for sharing information. We were told by several EDD auditors that they believed that they were only allowed to share information on employees with the FTB, and not information on employers. Thus, if they came upon an employer who did not file a Form 599, or a personal tax return, they believed that they could not share this information with the FTB.

#### Case Examples Illustrating Failure to Share Information

Case Example A: An EDD auditor cited a contractor whose contractor's license expired in 1980. In 1981 he reported to the EDD that he no longer had employees and quit filing employer reports effective April 1981. In 1984, an EDD auditor found, however, that the individual went back into the construction business later in 1981 and had unreported employees each year since.

The EDD auditor cited this individual for failure to report and failure to remit taxes. Total taxes and penalties due amounted to \$17,504. In addition, the auditor cited him for cash-pay to one unlicensed subcontractor and assessed an additional \$868. While this is the type of case that the ICE agreement covered, information on this case was not shared with either the CSLB or the DIR, each of whom could have taken action against this individual. The auditor stated that this information was not shared because: (1) his office has not been routinely sharing case information, (2) he believed that the other offices were probably too busy to take on additional cases, and (3) if the CSLB put the person out of business, the EDD could not collect their money and the contractor's employees would lose their jobs.

As a test case, we pursued this example. We found that neither the owner nor the person that he "subcontracted" with (his brother) filed income tax returns. In addition, only 2 of his 15 employees filed tax returns. (Note: We were not able to determine if the other thirteen had filing requirements.) Further, he did not have a valid contractor's license. If this information had been provided by the EDD to the CSLB, the DIR, and the FTB, each entity could have taken action.

Case Example B: As part of its standard audit program, the B of E reviews each audited taxpayer's State income tax returns to determine whether similar levels of sales are reported. However, if an auditee says that he or she did not file with the FTB, the B of E did not routinely convey this information to the FTB. During our study, B of E representatives met with representatives of the FTB to determine whether there were ways to share additional information. At that time, the B of E tentatively agreed to provide more information on the leads it gives to the FTB, and to notify the FTB if it uncovers individuals who have not filed individual income tax returns.

FINDING #2. INFORMATION WHICH IS SHARED WITH OTHER AGENCIES IS NOT ALWAYS USED BY THE RECEIVING AGENCY.

We found that when information is shared, often no use is made of the information by the receiving agency. For example, the DIR sends ICE information quarterly to the CSLB and the EDD. In 1984, the DIR sent names of 400 individuals cited for cash-pay violations to the EDD, and 388 contractors cited for having employees without being licensed to the CSLB. We found that these leads were not sent to field offices for action, but instead were kept at the respective agency's headquarters. We were told that this information was not being sent out because the headquarters officials believed that the field offices were too busy to handle the leads. During our study the EDD resumed sending these leads to the field.

We pursued several of these ICE leads generated by the DIR but not used by the EDD or the CSLB and found that many would have been productive if used. For example, the DIR issued a citation to an employer who engaged in cash-pay for 19 employees for the third and fourth quarters of 1984. Each employee earned \$1000 or more each month. The EDD did not follow up on this lead. In reviewing the EDD's files on this employer, we found that the employer reported these individuals as employees for the two quarters prior to the DIR citation (the first and second quarter of 1984), but showed no employees for the third or fourth quarter of 1984. Further, the EDD files showed that after the DIR citation, the employer filed an amended return with the EDD for the fourth quarter, showing wages of \$106,684, but did not amend the third quarter.

During the same year, the DIR received copies of 983 citations issued by the CSLB. These leads were on unlicensed contractors. We found that these leads were not used by most DIR field offices. In one DIR office which did not use any of the leads provided by the CSLB, one deputy stated that he tries to contact the CSLB when he works on cases that involve contractors. In one instance the DIR deputy found that a CSLB deputy had just completed a review of the contractor in question and had copies of all necessary paperwork, including copies of the contractor's payrolls. The DIR deputy was able to use the data provided by the CSLB deputy and, following a brief meeting

with the contractor, issued a citation for \$8800. The DIR deputy estimated that he spent about five hours working on the case, compared to between 20 and 25 hours that he estimated it would have taken without using the CSLB information. Even after that experience, however, that DIR office failed to take advantage of other CSLB leads available. The two main reasons stated for not using the leads provided were timing and staffing constraints.

Timing of Tax Filing and Reporting  
Complicates Information Sharing

In enforcing their respective regulations, each agency is working within the framework of a different time period. Specifically, the DIR can make a case against an employer paying cash within a few days of the occurrence. On the other hand, the EDD must wait until a quarterly payroll report is due, which can be as long as four months after the occurrence. The CSLB can cite a contractor at any time he is working. Finally, the FTB is not interested until after an income tax return is filed, which can be over a year after the occurrence.

These timing problems result in shared information not being used. For example, the DIR deputies must issue citations within one year of the occurrence. Since the EDD often audits several years of information, with the most recent information being at lease several months old, leads generated may already be too old for the DIR.

Staffing Constraints Have Limited Follow-Up on Leads

We were told that staffing shortages is one of the main reasons for not following up on leads provided by other organizations. Audit and investigations staff have sizeable workloads without working on leads furnished by other agencies. Consequently, staffing reductions in certain agencies in recent years have drastically affected overall audit and investigative activities. For example, the EDD audit staff has been reduced by 18 percent over the past three years while the number of employers has grown by 14 percent, as shown below:

EDD STAFF AND WORKLOAD TRENDS

FY	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
Audit Staff	304	258	261	248
Employers (000)	582	614	629	664

As this table shows, the number of registered employers is increasing while audit staff has decreased at EDD. Given the fact that a certain amount of work is fixed for the audit staff (such as administrative work and clearing obstructed claims) the potential workload per auditor is increasing rapidly. Further, since it is believed that the underground economy is growing,

the rate of growth of "total" employers may be significantly higher than the rate of "registered" employers.

Similarly, the CSLB has had large backlogs for several years. In 1984, the Legislature, through Budget Control Language, specified that the CSLB work primarily on consumer and industry complaints, giving second priority to investigating a three percent sample of new applications, until the backlog was significantly reduced. This has precluded the CSLB from working on ICE leads.

#### Increased Cooperation and Limited Effort Can Produce Results

While most DIR field offices do not use these leads, we found one office where the DIR deputies followed up on all CSLB leads on unlicensed contractors with employees in a simple and efficient manner. When they received a lead, they contacted the local CSLB office to get the name and address of the consumer who filed the original complaint against the contractor. The DIR would then send a simple questionnaire to the consumer asking whether the contractor had employees, and, if so, how many employees and for how many days. Based on the response to the questionnaire, the DIR deputy would mail a citation to the contractor. The citation would be for violation of Labor Code Section 1021 which prohibits an unlicensed contractor from using employees on a job where a license is needed. The penalty for this section is \$100 per employee per day. This process requires very little staff time but has been very successful.

Similarly, in another location we found that the DIR and the EDD field staff have a very good informal working relationship. Not only do they follow-up on leads received from each other, they sometimes make on-site visits together and issue citations at the same time to the same violators. Further, they are familiar with each other's needs and when they are at an employer's office they often obtain the information the other agency will need to write its citation. In addition, the DIR Deputy Labor Commissioners sometimes recommend a reduction of penalties if a cited employer brings in evidence that he or she has paid all back taxes to the EDD and has fully complied with State regulations (such recommendations are reviewed at the time of appeal hearings). At a third location, we found that the EDD routinely informs individuals it cites that they may be in violation of other State laws, and sends a copy of that notice (including the name and address of the cited individual) to the other agencies.

These examples are, unfortunately, the exception rather than the rule, and are based on the individual initiative of the field staff rather than on office-wide policies. We believe there is value in expanding these kinds of practices. For example, if the EDD started working on a case and found that there were problems the DIR might be interested in, the EDD could get the DIR involved from the start.

We believe the various State agencies should follow-up on leads generated by sister agencies. The benefits are easily demonstrated where good informal relationships between agencies' staff have resulted in substantial returns. Therefore, we believe all must be done to eliminate constraints to using information from other agencies including adding staff where it is shown to be cost-beneficial. (Staffing constraints are discussed in more detail in Chapter IV.)

**FINDING #3. THE QUALITY AND FORMAT OF SHARED DATA SIGNIFICANTLY LIMITS ITS USE.**

There have been two major problems voiced concerning the format of shared information. This first problem is the lack of a common identifier. This problem significantly limits certain State agencies from using high-tech means for comparing information. For example, the FTB stores information based on the taxpayer's Social Security Number while the B of E and the EDD use their own identifier numbers. Thus, it is difficult to match data files. At this time, the B of E is working to include the Social Security Number on its computerized records. However, the lack of a common identifier number continues to be a problem.

The second problem, which deals with individual leads, regards the quality of the information shared between agencies. Simply stated, the leads often contain too little information. We were told that the information obtained through the ICE agreement was often not useable because the providing agency was not aware of what information was needed by the receiving agency. Because of this, the "giving" agency transmits only a minimum amount of information to identify the subject.

For example, the CSLB has been providing only a copy of their citation to the EDD and the DIR. The citation does not include any information on whether or not the contractor had employees and thus neither the EDD nor the DIR auditors knew whether they should open a case. If the CSLB deputies included employee information--the number of employees and the number of days employed--both the EDD and the DIR could assess the size of the case and could make informed decisions about how to prioritize the case. During our study, the agencies involved in the ICE agreement have held several meetings to try to work on this, as well as other ICE-related problems.

Similarly, the B of E has been providing leads to the FTB on a one page form which contained the taxpayer's name, address, social security number, and the amount of adjustments to taxable sales. During our field work, B of E and FTB representatives met and the B of E agreed to provide additional information, including the audit report and quarterly detail on unreported sales. This will provide the FTB audit staff with better information to make audit decisions.

FINDING #4. STATE AGENCIES ARE NOT ACTIVELY IDENTIFYING AND USING NEW SOURCES OF INFORMATION.

As stated above, most State agencies have agreements to share information. However, there is very little research being done by State agencies to determine how they can use the information available to them.

Assembly Concurrent Resolution 36 of 1983 (ACR-36) directed all State agencies to "provide and share in a manner which does not violate legal rights to confidentiality or privacy, information regarding individual entities or taxpayers for the purpose of increasing the effectiveness and efficiency of the State's revenue collection efforts." To satisfy ACR-36, a workgroup was formed composed of representatives from the FTB, the B of E, the EDD, the Department of Motor Vehicles (DMV), and the State Controller's Office (SCO).

This group found that a large amount of information held by certain agencies was valuable to other agencies. Specifically, the group identified 17 different files with potential for data sharing, including files from each of the five agencies. However, the group also found that the largest hindrance to sharing this information was the lack of a common identifier number.

There is still much work to be done in the area of sharing information. There are numerous other sources of data available for sharing between State agencies, including agencies other than those mentioned above. However, after identifying the 17 data files that it felt could be shared, the ACR-36 workgroup was disbanded.

At this time, the FTB and the EDD are the only State agencies actively working on developing new sources of information. The FTB has a small unit which spends most of its time developing new sources of information and developing ways to use that information. For example, the FTB plans to run computer matches between its files and the B of E files to ensure that everyone holding a resale license is paying income taxes. It also plans to use information from counties on sales of nonowner occupied houses to ensure that capital gains were reported on tax returns. Similarly, the EDD is working with IRS, FTB, and other entities to locate ways to share more information, and similarly the B of E devotes limited resources to this area. However, much additional information is available and might prove to be more productive than other sources of information currently used. In addition it is understandable, but unfortunate, that these agencies are primarily concerned with data that can help them pursue their own agency's mandates and objectives. Thus, the rest of the State is basically doing without research in this area.

## Data Available at Local Levels Should be Considered and Used

In addition to information available at State agencies, much data is available at cities, counties and other local levels. For example, city and county building departments generally require building permits for new construction or major improvements to existing structures. Thus, they may have information on contractors which can be of value to the CSLB. In addition, cities and counties often receive fees from business taxes or for charges for business licenses. Therefore, it is to their advantage to work with both the B of E and with regulatory agencies such as the CSLB to determine whether there are businesses operating in their jurisdiction which they have not yet licensed. Also, cities and counties rely on the B of E to collect their portion of the sales and use taxes, and are interested in ensuring that all businesses are registered with the B of E. Finally, there are many federal and private sources of information available, such as from unions, professional associations, mailing lists, and from legitimate businesses interested in ensuring fair competition.

We found certain State agency field offices which have taken the initiative and are sharing information with local entities. For example, one DIR office has been working closely with the city business license office. The city office has agreed to withhold licenses from any applicant proposing to do garment work in the home, since this type of home work is prohibited by the labor code. This same DIR office is working with the local police department to control the illegal use of minors in door-to-door and other types of soliciting.

Similarly, the CSLB has an advisory committee of city and county building inspectors. This committee works to coordinate activities between the State and the local governments to ensure that contractors are adequately monitored. For example, in one major city, the building inspector reviews all applications for building permits to ensure that the builder is a licensed contractor. In doing so, the city building inspector ensures that the work will have some degree of professionalism, and at the same time helps enforce CSLB regulations.

Those State agency field offices which have taken the initiative to work with local officials have had positive results. However, this type of coordination has been left to the initiative of the field office employees rather than being directed from headquarters level.

## CHAPTER IV

### LIMITED AUDIT STAFF REDUCE POTENTIAL RECOVERIES AND OVERALL TAX COMPLIANCE

Staffing has been cited as a cause of many of the problems mentioned above. While additional staff is not a panacea which will solve every problem, it is one important element of an overall program to increase voluntary compliance which should be carefully considered. Unlike most State programs, increasing staffing in these programs will earn, rather than cost, the State money.

Increasing the high-tech methods of auditing (i.e. using computers to match data bases and identify nonfilers or underfilers) is an important step towards the cost-effective use of staff. For example, by matching computer tapes of filers who claimed IRA deductions on their 1982 income tax returns with tapes of individuals who were not entitled to this type of deduction, the FTB was able to generate assessments totaling over \$30 million. However, high-tech cannot replace the need for adequate staffing; rather, "high-tech" approaches must be used in concert with adequate staffing.

Field auditors are necessary for several reasons. They often must pursue cases identified by computers as having high potential. Also, many leads are generated through noncomputer sources, such as ICE leads. Finally, there are many transactions and/or business operations which are not subject to high-tech processing. For example, cash-pay violations cannot be directly detected by any automated system although some automated sources of data may identify potential violators. In such cases, though, staff is necessary to investigate and/or audit the cases.

FINDING #1. ALTHOUGH AUDITS ARE COST EFFECTIVE, AUDITOR STAFFING IN SOME AGENCIES HAS DECREASED.

As previously discussed in this report, it is widely believed that the underground economy has been growing over the past several years. At the same time, staff levels in some agencies which enforce laws dealing with this problem has remained the same or has been reduced. Further, since auditing is often considered part of overhead rather than providing program services, it is often subject to proportionately higher levels of cutbacks than other parts of agency operations when agency budgets are reduced. Even in agencies where audit staff has not declined, the increase in recoveries per hour indicates a need for more audits.

#### The Importance of Field Presence

As stated above, since it is not practical to audit each account or visit every worksite, tax and other enforcement

officials must rely on voluntary compliance. In fact, one major benefit of enforcement is that it creates a field presence to encourage additional voluntary compliance as well as recovering dollars. While the underground economy is expanding, however, the level of field presence is shrinking.

For example, the EDD lost approximately 13 percent of its total staff between 1980 and 1984. During the same period, its field audit staff was reduced by 18 percent while the number of registered employers increased by 14 percent. Because a certain amount of time must be devoted to certain program areas, such as the EDD's obstructed claims, staff cuts must be absorbed by programs considered to be lower priority. Unfortunately, auditing has often been the area cut. In one EDD field office we visited, the number of auditors was reduced over the past two years by 50 percent (from ten to five). In another office, the reduction was from twelve to five.

During that same period, the B of E audit staff was reduced by one percent. The number of resale licenses in force increased by 12 percent during that period.

As a result of the staff reductions, the number of audits and investigations in certain agencies has declined. For example, the EDD completed 22,859 audits in FY 1980 compared to 17,455 audits in FY 1984. At the same time, the number of investigations conducted by the EDD went from 20,143 in FY 1980 to 13,141 in FY 1984. In addition, the EDD receives a significant portion of its funding from the U.S. Department of Labor (DOL). The DOL has certain standards for performance, including auditing. The standard for audit penetration is four percent. This means that the EDD should audit four percent of all registered employers each year. By the end of 1984, EDD's audit penetration was only about two percent. Similarly, audits completed by the B of E declined from 24,768 in FY 1980 to 22,488 in FY 84.

Auditors have a high rate of return. For each hour of audit effort in FY 1984, the FTB recovered approximately \$256. Based on a midrange salary of about \$24 per hour for an auditor, this represents a return greater than 10 to 1. The B of E and the EDD also had rates of return of over 10 to 1 in FY 1984. Further, the rate of return on audit effort has been increasing, as can be seen in the chart below.

AUDIT RECOVERY RATIO

FY	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
FTB	8.7	9.7	10.7	11.4	10.7
B of E	7.6	7.9	8.1	10.0	10.4
EDD	7.3	5.5	6.1	9.2	12.2

(Note: These ratios were derived based on liability change per audit hour, divided by midrange auditor salary.)

The audit recovery ratios of over ten to one show that the State can realize a significant "profit" by increasing audit effort. Just as importantly, however, is the fact that the increase in this ratio over the four years suggests that voluntary compliance may be going down.

FINDING #2. COLLECTIONS BACKLOGS HAVE MORE THAN DOUBLED IN FOUR YEARS.

Another area that is being affected by staffing constraints is collections. Collection backlogs are increasing each year in the EDD, the FTB, and the B of E. Outstanding receivables more than doubled for the three agencies over the four years from \$492 million in FY 1980 to \$1,025 million in FY 1985, as shown below.

OUTSTANDING RECEIVABLES  
(in thousands of dollars)

FY	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
EDD	42,440	53,774	61,814	77,544	96,349
FTB	377,265	425,801	552,383	662,637	784,613
B of E	72,560	82,292	108,853	127,498	144,386
TOTAL	492,265	561,867	723,050	867,679	1,025,348

Although hours expended on collecting these receivables has grown by a small amount over the four years, the size of this problem indicates that it needs much more attention. As mentioned above, increased staffing in audits, investigations, and collections would be cost-beneficial. Not only would every dollar spent by the State result in substantial returns to the State, but it would also enable the State to expedite the collection of outstanding receivables currently exceeding \$1 billion.

## CHAPTER V

### ENFORCEMENT MECHANISMS AND STATUTES NEED REFORM

Audit selection criteria currently used by State agencies do not directly focus on the underground economy. Generally, each agency selects auditees based on potential direct recovery. Further, agencies involved in dealing with the underground economy have various penalties that they can use when they find individuals who participate in the underground economy. However, these penalties are not fully used (or are not adequate) to control the underground economy.

FINDING #1. AGENCIES' AUDIT SELECTION CRITERIA DO NOT ADEQUATELY CONSIDER THE UNDERGROUND ECONOMY OR THE VALUE OF INCREASING VOLUNTARY COMPLIANCE.

The agencies reviewed in this study have different criteria for selecting auditees. Because each agency's criteria focus primarily on those areas related to their individual mandates, the selection criteria do not focus on the underground economy; further, they do not address the value of increasing overall voluntary compliance.

The California Legislature has mandated audit selection priorities for the FTB, the B of E, and the CSLB. The two taxing agencies have been mandated to direct audit efforts to maximize direct recoveries. Although this is certainly an important criteria, it restricts the individual agencies in trying to maximize overall voluntary compliance. Similarly, the California Legislature directed the CSLB to give first priority to mediating consumer and industry complaints, and second priority to investigating a three percent sample of new applicants. Consequently, the CSLB has been unable to pursue activities designed to encourage voluntary compliance. Before these constraints were placed on the FTB, the B of E and the CSLB, they had several proactive programs to encourage greater compliance. For example, the CSLB representatives reviewed construction advertising to ensure that advertisers were licensed and that they included their license number on their ads. While they continue to do some sampling of all types of taxpayers, the FTB and the B of E previously conducted more audits of smaller taxpayers to create a greater "field presence." In addition, the B of E previously spent more time looking for unregistered retailers than it does now.

The underground economy is also not the highest priority for the EDD's Employment Tax Branch. The EDD obtains the majority of its funding from the federal Department of Labor (DOL). In administering the unemployment insurance program, the audit staff's highest priority is clearing "obstructed claims." An obstructed claim is a claim for unemployment compensation where EDD's records show a different employment history from that claimed by the unemployed worker. For example, if a worker

claims eligibility for unemployment insurance benefits based on employment with a firm that did not report that worker as an employee, an EDD auditor must determine whether or not the individual was an employee and therefore eligible for benefits. This determination must be made within ten days.

Clearing obstructed claims is an important element of the EDD's program and results in significant recoveries. However, this workload consumes a majority of EDD's audit resources. Because of this, the EDD Tax Branch is not able to direct its resources to those areas which might provide the greatest amount of voluntary compliance, or even to ensuring that employers are registered.

The DIR is not a tax collecting entity and, although it collects penalties based on citations, it is not directly concerned with the loss of State tax revenue. While the DIR's fundamental concern is that employees are protected and fairly paid, the DIR's Bureau of Field Enforcement enforces numerous provisions of the labor code, including those sections covering worker's compensation insurance requirements, minimum wages, child labor, and cash-pay.

**FINDING #2. DIR DEPUTIES HAVE NOT BEEN ADEQUATELY TRAINED IN METHODS TO QUANTIFY THE EXTENT OF UNDERGROUND ECONOMY ACTIVITY.**

In enforcing certain provisions of the Labor Code, DIR deputies can issue citations based on the number of violations. For example, the penalty for cash-pay violations is \$100 per employee per violation. DIR deputies have not, however, been trained in methods to reconstruct prior periods, so they will often issue the citation for only the current period or for those periods when an employee is willing to testify that cash-pay occurred.

In similar circumstances, we found that other agencies use various methods to reconstruct what most likely occurred when records are not available. The B of E, for example, determines taxable sales based on inventory purchases. The EDD estimates payroll based on the number of employees required to run a business times the number of hours the business operated.

Although the DIR has no formal provisions for this method, and provides no training, we found two instances where DIR deputies used this technique on their own. One deputy cited a contractor for cash-pay and based the citation on standard labor hours to complete the types of buildings the contractor had completed that year. Another deputy cited an employer who hired several laborers to pick strawberries. The deputy found estimates of how many hours are required to pick an acre of strawberries, and multiplied this times the acres picked. None of the other DIR deputies we interviewed, however, had heard of using the technique of reconstruction.

FINDING #3. STATE AGENCIES ARE NOT SUFFICIENTLY PURSUING CRIMINAL PENALTIES WHICH WOULD INCREASE DETERRENCE.

State agencies are not using many of the sanctions available to them for use against violators. The emphasis in the field is to get corrective action and close the case. Most of the time "corrective action" means collect the taxes due plus a small penalty or to get an individual to start complying with the law. This is in contrast to the penalties which are often available, including large fines, loss of license, and/or criminal prosecution. Thus it is very profitable to cheat, and not very expensive if you get caught.

There is a broad range of penalties available to the agencies we studied. These penalties can be invoked for a variety of offenses, ranging from refusal to provide records or failure to file reports, to nonpayment of taxes due. The taxing agencies can recover the taxes due plus penalties and interest. They also have certain criminal sanctions which they can impose.

The penalties normally take one of three forms: monetary penalties; action against a license; or criminal penalties. For taxing agencies, the monetary penalties are often based on a percentage of the taxes due. For example, the EDD is primarily concerned with recovering the money owed by employers. In addition to the past due taxes and interest, it can assess monetary fines (usually 10 percent of the taxes owed). Nontaxing agencies can issue citations with monetary fines. For example, the CSLB can issue citations for violation of the Business and Professions Code with civil penalties up to \$2,000. The CSLB can also take action against a contractor's license, including suspension and revocation.

State agencies can also initiate criminal proceedings although most sanctions are misdemeanors rather than felonies. For example, under the Unemployment Insurance Code it is a misdemeanor for an employer to (1) withhold information from the EDD, (2) fail to file reports, (3) refuse to pay required taxes, or (4) refuse to withhold income taxes from employees. The Unemployment Insurance Code also contains certain felony provisions, including signing a fraudulent return under penalty of perjury or not remitting withheld income tax. However, we found that even in blatant cases of violations, most State agencies are hesitant to prosecute.

As an example of the current attitude regarding prosecuting cases, we found a case that the EDD had developed. An employer had not only failed to report his employees to the EDD, but had actually collected withholding taxes from the employees and used them for his business. When the EDD auditors found this case, they assessed the back taxes and a penalty, but did not prosecute, even though this violation is covered by one of the few felony laws that the EDD can use. The EDD representatives told us that they did not pursue this case because they did not

have the time to prepare the case for court, and because they felt that the district attorney would not accept their cases. However, they admitted that they had not tried to get the district attorney to take any cases for several years.

As another example, we found a case that a B of E auditor had taken to a district attorney. The case involved over \$2,500,000 in taxes and penalties owed the State. While the deputy district attorney agreed that it was probably a good case, he told the auditor to conduct a criminal investigation and bring the case back when all the work was done. Since the B of E does not have any trained investigators, the auditor handling this case was trying to prepare this case for the district attorney, but was not sure how to do so.

We were given several reasons why criminal penalties were not often pursued. To prepare a case for trial takes a large amount of time, and with staffing being a critical issue, it is difficult to devote significant resources to just one case. In addition, we were told that the objective of enforcement is to get the individual back into compliance, rather than to prosecute. This argument does not recognize the deterrent effect on others who are on the edge of deciding whether or not to cheat.

Further, there frequently is little managerial direction for field staff to take cases to prosecution. For example, the tax amnesty law added Section 226.6 to the Labor Code which provides additional penalties for violating the Labor Code. However, none of the DIR deputies in the field we contacted had heard of the section, much less had any direction on how to use it. In addition, since field staff are often evaluated based on cases completed, there is actually a negative incentive to take the time to pursue prosecution. Finally, there is no training provided to most auditors on how to prepare a case for trial.

Even if the agencies tried to take more cases to prosecution, they would find that district and city attorneys generally are reluctant to take tax cases for several reasons. First, they have limited resources. Second, cases are normally misdemeanors rather than felonies. Third, they are complicated, confusing, time consuming, and it can be hard to convince a jury that a crime has been committed. Fourth, since the auditors and investigators are not trained on how to prepare a case for trial, they are in a poor position to "sell" the case to the district or city attorney. Finally, tax cases do not have a constituency. Specifically, there are no vocal complaints if the attorneys choose not to take the case.

In contrast, the FTB has had significant success in prosecuting its cases with district and city attorneys. The FTB has learned the value of successful prosecutions on increasing the level of voluntary compliance, and devotes significant resources to these cases. The FTB has learned how, and takes

the time, to properly prepare their cases and to "sell" them to the district and city attorneys. They then capitalize on these cases by publicizing them to the greatest degree possible.

Due to privacy considerations, information on tax violations cannot be released unless a case is taken to court. Thus, without additional prosecutions it will be difficult to get publicity, and the resultant increase in voluntary compliance.

**FINDING #4. STATE AGENCIES ARE NOT USING CROSS-AGENCY PENALTIES WHICH WOULD PROVIDE MAXIMUM DETERRENCE AND RECOVERIES.**

Because of the existence of differing tax and labor statutes, each with their respective penalty provisions, there are several cross-agency penalties available which are seldom used. The use of all available penalties by the respective taxing and enforcing agencies would further maximize deterrence and recoveries. For example, Section 98.9 of the Labor Code requires the Labor Commissioner to deliver a certified copy of the finding of violation to the registrar of the CSLB if the Labor Commissioner finds that a licensed contractor has willfully or deliberately violated any provision of the Labor Code. Section 7110.5 of the Business and Professions Code requires the Registrar of the CSLB to initiate formal disciplinary action against the licensee within 30 days. We were unable to find any examples where this type of notification had been made. A DIR official sent a questionnaire to all area offices during our field work to determine how often this technique was used. He found that none of the DIR field offices were using it.

In addition, every audit or investigation resulting in cash-pay or other underground economy sanction could result in penalties from the EDD if the recipient was inappropriately claiming unemployment insurance, from the FTB if the recipient failed to claim income on his or her income tax return, or from Medi-Cal or other assistance programs if the recipient of cash-pay was inappropriately using these programs. Further, Business and Professions Code Section 7110 states that any violation of the State's labor laws, compensation insurance laws, or unemployment insurance laws constitutes cause for disciplinary actions by the CSLB.

Finally, the ICE agreement provides a vehicle by which agencies can "piggyback" penalties based on other agencies' audit work. For example, when an EDD auditor finds an employer involved in cash-pay, the auditor will recreate what the payroll should have been and then assess taxes due. Using this same information, a DIR deputy can issue citations for cash-pay and impose a penalty of \$100 per employee per violation. However, as discussed above, ICE leads have not been adequately shared or used in the past although attempts are being made to correct these problems.

**FINDING #5. THERE ARE FEW PENALTIES FOR REPEAT OFFENDERS AND THE NEED FOR APPROPRIATE FOLLOW-UP AUDITS OF VIOLATORS.**

There are very few provisions in the State's tax and labor codes for penalties to be increased in the case of repeat offenses, and the penalties which do exist are for the most part relatively minor, although in other sections of California statutes repeat violators may be subject to trebled fines. For example, the FTB may prosecute for fraud if a taxpayer habitually misstates his or her tax liability, and the DIR can increase the penalty for repeat offenses in the areas of child labor and garment contractors, and the EDD can impose a ten percent penalty for intentional misstatement or failure to file. The CSLB and the B of E have no specific provisions for repeat violators.

In addition, there are few provisions for reinspection of cited businesses to ensure that corrective action has been taken. In many enforcement areas, follow-up inspections is one of the key steps in ensuring compliance. For example, Cal/OSHA and the Licensing and Certification Division of the Department of Health Services have procedures for following up on their inspections to ensure that corrective action has been taken. We found no such provisions in the activities we reviewed.

As a result, an employer or taxpayer can continuously estimate his or her chances of getting caught. If the chances of getting caught and the penalty if caught are both low, the employer or taxpayer may decide that it is advantageous to continue to cheat even after being caught. For example, since the DIR penalty for cash-pay is \$100 per employee per pay period, an employer may choose to engage in cash-pay, believing that he or she may never get caught, but if caught will only have to pay a small fine. Because of the potential benefits of increased deterrence, follow-up audits should be conducted more frequently and in a routine manner.

**FINDING #6. ENFORCEMENT AGAINST EMPLOYEES INVOLVED IN CASH-PAY IS INADEQUATE.**

Although there are no statistics available, it is widely believed that in a large number of cash-pay cases the employee is not declaring the cash on his or her income tax return, and/or is fraudulently collecting unemployment insurance benefits. As discussed before, when cash-pay is discovered through an audit or investigation, certain actions are taken against the employer. However, very little is done to ensure that the employee is brought out of the underground economy.

If the CSLB or the DIR discovers the cash-pay violation, they take no action to ensure employee compliance. Further, if the DIR is involved because of a pay dispute and actually seizes assets from the employer and pays the employee directly, the DIR

will not withhold taxes or file a Form 599 reflecting this payment.

If an EDD auditor discovers the cash-pay and can obtain the employee's name and Social Security Number, the auditor will schedule the quarterly earnings. If this information is for earnings over five calendar quarters old, nothing is done with it. If this information is for the most recent five calendar quarters, the EDD computers will check to see whether the employee received any unemployment insurance benefits during those quarters. If he or she did, the computer generates a letter to the employer asking for additional verification of employment. If the employer returns the letter showing that the individual was employed at the same time that he or she was collecting unemployment compensation, the EDD will attempt to collect the amounts paid. If the employer does not return the letter, then the case is dropped. If the employer and employee were acting in collusion, we believe that the employer in this case would likely not respond. Therefore, the lack of follow-up on nonresponses may be allowing these employees to keep their fraudulently obtained benefits.

**FINDING #7. PENALTIES FOR NOT CARRYING WORKER'S COMPENSATION INSURANCE ARE INADEQUATE.**

Both the CSLB and the DIR deputies will issue citations if they discover employers who do not have worker's compensation policies in effect. In addition to issuing the citation, they can stop work on the site until a policy is obtained. We found that although not having a policy is considered a major problem, warranting work stoppage, the penalty for not having a policy is small compared to the perceived advantage of violating the law.

The penalty for not having a worker's compensation policy is only \$100 per employee. However, since the cost of worker's compensation insurance can be as high as 25 percent of salary costs, if an employer believes that the likelihood of being caught is small, he or she may decide that it is less expensive to not have a worker's compensation insurance policy. If an employee is hurt while on a job where the employer did not carry worker's compensation insurance, the employee may be entitled to benefits from the State's uninsured employer fund. The State must then sue the employer to recover the money for the fund.

In contrast to worker's compensation insurance, when an employer does not contribute to unemployment insurance, he or she is required to pay all past-due taxes plus a ten percent penalty. If a similar requirement were placed on employers who did not carry worker's compensation insurance, i.e. if they had to pay premiums for those periods when their employees would have been covered by the State's uninsured employers fund plus a penalty and interest, the incentive to not carry worker's compensation insurance would be significantly reduced.

FINDING #8. THERE IS CONTINUING CONTROVERSY OVER THE DEFINITION OF AN INDEPENDENT CONTRACTOR VERSES AN EMPLOYEE.

The definition as to whether a worker is an employee or an independent contractor is very important since an employer has much greater responsibility for an employee than for an independent contractor. For example, an employer is required to withhold income taxes, pay payroll taxes (social security and unemployment insurance) and provide worker's compensation insurance. An independent contractor is responsible for these on his or her own.

Certain other states use a so-called "A-B-C Test." Under this system, an individual is considered an employee unless the following three circumstances exist:

- (1) The individual has been and will continue to be free from control or direction over the performance of the services, both under his contract of hire and in fact; and
- (2) The service is either outside the usual course of the business for which such service is performed, or such service is performed outside all the places of business of the enterprise for which such service is performed; and
- (3) The individual is customarily engaged in an independently established trade, occupation, profession, or business of the same nature as that involved in the contract of service.

California uses common law rules in determining who are employees and who are independent contractors. There are several tests used to determine status, the most important of which is whether the so-called employer has the right to control the work. For example, if an individual is responsible for delivering a product or service, and has discretion as to how, where, and when he or she will create that product or provide that service, then the individual is probably an independent contractor. However, if the principal has the right to control the details of the work, then there is an employment relationship.

Unfortunately, there are so many gray areas that volumes have been written about this distinction and ambiguous cases are judged by comparison with case law. The federal government also uses case law and has been struggling with this same issue for several years.

Because of the differences between State laws and because of the gray areas in California and federal laws defining employees, employers may have difficulty in determining whether they are hiring employees or contractors. Further, these laws

may not be uniformly applied State-wide. Finally, the vague definitions contribute substantially to employer and employee abuse of labor and tax laws relating to cash-pay transactions.

## CHAPTER VI

### REORGANIZATION COULD INCREASE EFFICIENCY AND LEAD TO GREATER RECOVERIES AND DETERRENCE

Many of the problems discussed in previous chapters exist, in part, because of the fragmented organization of California's taxing agencies. California's organization of tax collections activities differs significantly from the vast majority of states which have consolidated all activities into a single department. California's division of responsibilities among three different agencies unavoidably results in various forms of inefficiency. For example, the independence of each agency sometimes stifles the exchange of information between agencies. Further, the individual goals and objectives of each agency are not always conducive to achieving maximum benefit for the State. Finally, many overhead costs are duplicated.

While California's current organization may be the most appropriate and the existing inefficiencies merely the cost of being such a large, diverse State, several past studies have recommended reorganization of the State's taxing agencies. These studies have recommended everything from centralizing certain operations to completely restructuring the State's tax collecting agencies. One of the first studies in this area was presented in 1927 by the California Tax Commission. Our Commission also recommended consolidation of taxing activities in a report issued in 1964.

The most recent discussion of this topic was presented this year by the Governor's Tax Reform Advisory Commission. The Tax Reform Advisory Commission issued their report on the State's tax structure on February 11, 1985. This report contained proposals regarding restructuring all the State's tax systems with the goal of achieving tax reform and a simplified and more equitable tax system. One of their recommendations was to consolidate the FTB and the B of E into one State department. They also recommended a State tax court system to improve justice in the tax system, and a Tax Advisory Commission to provide advisory capacity for the Governor on tax matters. In making these recommendations, the Commission cited potential for improved organization, reduced overhead costs, and better service to taxpayers.

Although we did not conduct a detailed analysis of the advantages and disadvantages, costs, increased revenues, and viability of reorganizing State taxing and revenue agency responsibilities, our work on this study indicates that there could be substantial benefits to the State, particularly in combating the underground economy. Therefore, we believe that the current organization of the State's taxing agencies warrants serious consideration in light of the following findings.

FINDING #1. LACK OF A SINGLE REVENUE AGENCY RESULTS IN DUPLICATION.

Each taxing agency, including the EDD Tax Branch, has evolved based on its individual needs. Thus, the existing monitoring and management information systems appear quite different. However, there are many systems and activities which are duplicative. For example, each agency has a unique collections system for billing delinquent taxpayers and taking subsequent actions such as issuing warning letters and finally attaching wages or placing liens on property.

Similarly, each agency maintains its own computerized data base files. These files are also unique, and, as discussed in Chapter 3, are often not compatible due to different identifier numbers. However, much of the data contained in the files is duplicative. Examples of duplication include the following:

- The B of E, the FTB and the EDD all have basic identification information on a business which sells at retail and which has employees. This identification information would include such things as the business name and address.
- Some of the payroll information maintained by the FTB and the EDD is the same. The FTB allows the business a deduction for paying wages, while it imposes income tax on the employees receiving the wages. The EDD collects payroll taxes from the employer and credits the employee's unemployment and disability insurance accounts.
- The FTB and the B of E also receive information on sales from each business.

In those cases where the information provided to the different agencies does not match, an audit may be warranted. For example, if on individual files a return with the B of E showing retail sales, but does not file an income tax return, or if he or she files both returns but shows different amounts for gross sales, an audit lead should be generated. (Note: this is similar to the idea of high-tech data matching, except it would be done within each data file rather than by trying to match files on separate data bases.)

Therefore, having three agencies involved in major revenue activities results in some level of redundant systems and duplication of certain overhead activities. In addition, the separation of activities hinders the sharing of information.

FINDING #2. BECAUSE THE STATE'S REVENUE AND ENFORCEMENT AGENCIES ARE SEPARATE, THEY HAVE NOT WORKED TOGETHER ON TASK FORCES TO COMBINE EFFORTS ON BLATANT CHEATERS.

During our field work we found examples of taxpayers or licensees who were blatantly disregarding many State laws. While these individuals had been caught by one State agency, quite often that agency was unable to fully punish the offender because of limited information, insufficient sanctions, or staffing constraints.

For example, we found a B of E case where an individual grossly understated taxable sales and failed to file income tax returns or EDD payroll reports. The B of E auditor was trying to develop a case for prosecution on his own. This information was shared with the FTB, and they were considering a separate audit. The EDD and the DIR were not formally notified of this case.

We believe that a task force of auditors and enforcement agents including representatives from the B of E, the FTB, the EDD and the DIR could build a strong case against this type of chronic tax evader, and not only get maximum corrective action, but could also generate publicity resulting in greater voluntary compliance.

FINDING #3. SEPARATE AUDIT STAFFS PRECLUDE USE OF THE "SINGLE AUDIT" CONCEPT WHICH MAY RESULT IN MISDIRECTED AUDIT WORK.

Private industry normally relies on the "single audit" concept in fulfilling audit requirements in the most efficient manner. Under this concept, one audit organization conducts an audit of an entire firm, testing all significant areas. The auditor (or team of auditors on large assignments) tests inventory, payroll, accounts receivable, accounts payable, and so on. On large assignments the team may consist of specialists in technical fields, but for small audits a single auditor may be responsible for all areas. If the auditor suspects a problem in a technical area or an area he or she is not familiar with, he or she can bring in support staff to help resolve that problem.

The federal government is moving to the same concept. In the past, a city receiving Environmental Protection Agency (EPA) funds for a new sewer project and Housing and Urban Development (HUD) funds for a redevelopment project would be audited by both agencies. A larger city, involved in many federally sponsored projects could expect several federal audits each year. Under the single audit concept, one federal agency is considered the lead agency for each entity. (For example, HUD might be the lead agency for the smaller city while EPA is the lead agency for the larger city.) Thus, HUD would conduct a comprehensive audit of the smaller city, testing not only the expenditure of HUD funds, but also EPA and any other federal funds spent by the city.

A similar single audit concept could be implemented by the State. Currently, while a business may be subject to audit or review by several agencies, it may in fact only be audited once over several years. That audit would only cover the requirements of the auditing agency. If the audit staff had a basic understanding of all State laws and regulations they could conduct a general audit and call in specialists as needed.

While it would be unreasonable to expect all State auditors to immediately become experts in all State tax laws, it would be possible to train new auditors to be "generalists" and rely on existing highly trained auditors to work in teams reviewing larger organizations and to provide expert support for generalist auditors working in smaller organizations.

**FINDING #4. CONFLICTING OR DISSIMILAR OBJECTIVES LIMIT THE OVERALL EFFECTIVENESS OF STATE ENFORCEMENT ACTIVITIES.**

As discussed in Chapter III, agency concerns for their own effectiveness create problems which impede the sharing of information. Since each agency is concerned with its own performance (often measured in number of cases closed) and collecting its own revenue, the overall benefit to the State is often overlooked. Specifically, information is not shared, audits are not coordinated between agencies and task forces are not used. A consolidated revenue department could help reduce these problems.

Because each agency has its own objectives in mind, rather than a State-wide objective, it may take certain actions which are appropriate when considering only that agency's objectives, but which are not appropriate when all of the State's objectives are considered. For example, if an EDD auditor finds a blatant nonfiler, the auditor might be satisfied by recovering back taxes. If a B of E auditor were to find this same individual, the auditor might try to get the individual's resale license revoked, thus removing the individual's ability to conduct business. Finally, if an FTB auditor were to discover the individual, the auditor might pursue criminal sanctions. Thus, an individual's fate might be determined by which agency catches him or her, rather than what he or she did.

Further, once a case is closed from one agency's perspective, officials of that agency are generally no longer concerned with the State's interests. For example, once the DIR completes a cash-pay case it will usually send a lead to the EDD, but in most cases does no follow-up to ensure the lead contained sufficient information for the EDD, that it was used, or even that the lead was received. In those field offices where the DIR deputies and the EDD auditors maintain contact, officials from each agency are concerned about the other

agencies objectives and thus help by providing additional information and other assistance. Unfortunately, while the official policy is to cooperate fully, at the field level this is the exception, rather than the rule.

## CHAPTER VII

### RECOMMENDATIONS

The underground economy has no doubt existed ever since society imposed taxes on businesses and individuals. And it will probably always exist to some extent--government, quite simply, cannot be large enough to monitor, identify, and enforce all violations.

Be that as it may, this Commission and our Blue Ribbon Study Advisory Committee believe that California State government can do much more to encourage voluntary compliance, deter growth of the underground economy, substantially increase its monitoring and enforcement effort, significantly increase State tax revenues, and minimize the generally negative effect the underground economy has on our economy.

The opportunities are monumental. If the State only recovers five percent of revenues lost to the underground economy, State revenues could increase by \$100 million. Overall benefits from increased compliance, reduced unemployment insurance claims and other nonquantifiable savings would further increase this total substantially. The members of our Commission believe, at minimum, such improvements can occur if the recommendations outlined in this chapter are implemented. Although we attempt to provide a detailed discussion of how improvements should be made, we do not believe these represent the only, and may not even be the best, approaches to improved operations. Rather, what is important is that action be taken to improve our organization of responsibilities, information management, priority setting, enforcement tools, and dedicated resources to heighten detection, enforcement, and, ultimately, voluntary tax compliance.

### ORGANIZATION

Recommendation #1: The Governor and Legislature should consider reorganizing some or all State taxation responsibilities. The final determination on whether or not to reorganize, and if so, the level of reorganization necessary should be based upon the results of an in-depth study of all responsibilities of existing State tax agencies conducted by a team of specialists with expertise in taxation, banking, management, computer systems, and other appropriate disciplines. This team should be guided by an oversight panel consisting of representatives from the business community, organized labor, the State Bar, the State Board of Accountancy, and other affected groups as may be considered necessary.

At least 45 other states have a single state revenue agency. The federal government is moving to a single agency concept in auditing federal fund recipients, and federal Internal Revenue Service auditors conduct generalized audits

covering income tax and social security tax. California's current organization may be the most appropriate one; however, without an impartial study it is impossible to be certain one way or the other.

Numerous studies have identified the need for a consolidated revenue agency in California and the operational problems it would solve. Similarly, this study has pointed out that there are problems in coordinating enforcement, sharing data, operating duplicative systems, and agreeing upon a State-wide tax enforcement policy and direction. These problems should be considered in any study regarding consolidating the revenue agencies.

Our Commission believes that there are several different alternatives for reorganization which should be considered. Below are brief descriptions of two possible levels of reorganization. These alternatives could be accomplished through the creation of a new organization or through transfers of responsibilities to an existing organization such as the Franchise Tax Board or the Board of Equalization.

Alternative #1: The activities of the Tax Branch within the Employment Development Department could be consolidated with the activities of the Franchise Tax Board. The EDD can continue to handle obstructed claims and benefits for the unemployed through use of computer tapes supplied to it by the central revenue and taxation agency.

Alternative #2: In addition to transfers discussed in Alternative #1, the State might experience increased efficiencies through improved data base management and elimination of duplicative administrative overhead if it consolidated some or all of the functions of the Board of Equalization and the Franchise Tax Board. As this report has indicated, high technology information management is critical to the identification of participants in the underground economy and other forms of tax evasion. Optimal efforts at monitoring and enforcing State tax laws depend upon effective data management and tax compliance objectives and operations that are fully coordinated and not at opposition with one another. As long as the State continues to operate multiple tax agencies, certain inefficiencies will exist.

#### Benefits of Consolidating Tax Administration Into a Single Organization

Although there will be some initial costs, there would be significant benefits in consolidating the three tax entities. One of the major benefits of consolidation would be an increased ability to take advantage of automation and using common data bases. Specifically, consolidation would make it easier to share data, and would give data users greater freedom to discover what data is available. In terms of planning,

consolidation of revenue activities would also allow greater freedom for the movement of resources to achieve necessary objectives. These objectives include maximizing revenue as well as voluntary compliance. Additional benefits result from savings in administrative overhead. These include such functions as office administration (including hiring and training), maintaining field offices, and operating computerized data files.

Consolidation would also allow for greater nonenforcement ways of increasing voluntary compliance. Consolidation of field offices could allow for one-time registration, and the ability for taxpayers to obtain information and advice at one time in one place.

Consolidating collections would not only result in eliminating duplicative systems, but in those cases where a taxpayer is unable to pay his or her tax bill, it would allow a single State representative to review the total of State claims and decide whether to attempt to negotiate for a repayment schedule or to attach property. Further, this would eliminate any intra-agency competition for collections.

In the enforcement area, consolidation would reduce or eliminate many of the problems discussed in this report. A State revenue and taxation department could establish certain goals and objectives for State-wide tax administration. It could make more informed decisions on what type of enforcement action to take, based on a taxpayer's degree of noncompliance with all State taxes.

Only through an in-depth study can the State determine whether the current organization is optimal or whether reorganization is warranted. If this study shows that some level of reorganization is appropriate, it should provide details on how that reorganization should take place. This study should also include a recommendation on whether or not a new agency or the agency to which transfers are made should be directed by elected officials. If the study shows that no reorganization is necessary, it should at the least describe what functions, if any, should be shifted between agencies.

The completion of a thorough study outlining the optimal organization of State revenue and taxation responsibilities should not delay the implementation of other improvements which we strongly believe will improve the overall effort to take action against participants in the underground economy, increase tax collections, and improve overall voluntary compliance. Therefore, we recommend immediate implementation of the following recommendations.

Recommendation #2: The Legislature and Governor should, through statute or executive order, establish a Multi-Agency Task Force to conduct complete audits and investigations of

blatant tax violations and cash-pay transactions. This task force should consist of representatives from the FTB, the B of E, the EDD, the CSLB, the DIR, district attorneys, and the Attorney General's Office. Each Task Force should also have a public information officer to ensure that the Task Force's efforts are adequately publicized. Representatives from other State agencies should be available to serve on the Task Force as needed.

The Task Force should be staffed with both investigators and auditors with backgrounds in sales tax, income tax, cash-pay transactions, unemployment insurance, law enforcement, and any other appropriate skills. General administrative overhead could be absorbed by the participating agencies or by the reporting agency itself.

However, to ensure that the individual departments do not suffer from the loss of personnel to the Task Force, we believe that the Task Force should be specifically funded separately from the departments.

For such a Task Force to be effective, it must be given very high priority by the Governor and Legislature. Consequently, we believe it should report directly to the Governor or through a member of his Cabinet and perhaps be established in statute with a sunset provision for evaluation and possible reauthorization four years after its effective date. Initially, the Task Force should have teams of approximately 5-10 staff in each major metropolitan area. Additional teams should be established as soon as possible once their value is determined.

In addition to receiving referrals from the various State taxing agencies, the Task Force should utilize an advertised "hot-line" for receiving external referrals. This Task Force should focus and target its efforts on those groups which will result in the greatest publicity, highest visibility, and increased voluntary compliance; its effectiveness should be measured, in part, on the basis of publicity achieved, not simply dollars collected.

The Task Force would have numerous benefits, including (1) generating greater voluntary compliance through publicity; (2) maximizing return on recoveries from blatant tax evaders; (3) minimizing costs through elimination of duplicative audits; and (4) providing cross-training opportunities by allowing auditors and investigators opportunities to become familiar with other agencies' laws. Use of the Task Force would also overcome organizational problems such as agency parochialism and timing problems.

## INFORMATION SHARING AND USE

Recommendation #3. The Governor and the Legislature should require representatives from the EDD, the FTB, the B of E, the DIR, the CSLB <sup>1/</sup> and other appropriate State agencies to form a standing committee to continuously study opportunities for sharing information, improving formats for the information, and eliminating access obstacles. This committee should also include representatives from the federal government, local governments, other states and nongovernmental entities, as appropriate.

The sharing of information, especially through the use of high-tech means when available, has proven to be very valuable when used. It results in greater voluntary compliance, and is highly cost-effective. Unfortunately, the identification of ways to develop and use this information has been and continues to be too low of a priority.

We believe that a standing committee should be established to continuously look for new sources of information and new methods to share the information and to foster its use. This committee should also work with the federal government, local government, and other states as well as nongovernmental sources of information such as business groups and unions.

Because the FTB is probably the State taxing agency most advanced in data applications, we believe it should serve as lead agency. Such a committee should initially develop a set of objectives and an annual plan and submit it to all participants for review. The committee should also monitor the implementation of its own recommendations and submit a report to the Governor and his Cabinet on the results of its work. We believe the committee should initially focus on three areas: (1) improving use of data currently shared, (2) identifying State data bases not currently used, and (3) identifying and developing use of local government automated data bases such as building permits, property tax rolls, and local business licenses.

This committee should also (1) identify the deficiencies in the information each agency receives from other agencies; (2) determine what information is critical to the identification of potential violators; and (3) help the referring agencies modify their forms to improve the quality of information shared.

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<sup>1/</sup> The CSLB is the only entity of the Department of Consumer Affairs included in our study. We believe, however, that many of the recommendations contained in this report are applicable to other regulatory boards and bureaus.

As stated above, a small amount of additional information can make a lead much more valuable to the receiving agency. When conducting our field work, we learned that leads on potential violations could be significantly improved if the agency generating the lead knew how the receiving agency would use it and could therefore provide the information critical to follow-up.

One example we identified during our study that the Advisory Committee should assess is the following. If the CSLB included information on its citations on how many employees an unlicensed contractor had, and how many days those employees worked, the DIR deputies could immediately issue citations with minimal additional field work. Similarly, the EDD auditors schedule payroll information by employee, by pay period, to determine back taxes owed. If they provided that detailed information to the DIR, the DIR deputies could issue citations with minimal additional field work.

Finally, this committee should identify and work to eliminate barriers to sharing information. These barriers include access to data problems, data format problems, and the problems which result from organizational parochialism. For example, unions might be hesitant to share information out of fear that the State may take actions against an employer before the employer fully paid into the union trust fund. Thus, it may be necessary to pass legislation protecting the first claim of any entity providing information. Such issues should be evaluated by this committee.

Recommendation #4: The Legislature and the Governor should require all State agencies to use a common identification number or a system of cross-reference numbers for all businesses.

The Tax Amnesty Act (AB 3230) directed the FTB to develop and maintain a cross-reference system for tax information held by the FTB, the B of E, and the EDD. The cross-reference system is to be based on available information from the three agencies. This system will enable State tax administrators to access and use data to identify taxpayers who are registered or who filed returns with one State agency, but not with others. Much progress has been made in this area. This provision did not go far enough, however, in that it does not include nontaxing agencies such as the DIR and the CSLB.

By expanding the requirement for a common number or a cross-referencing system, the Legislature and the Governor will provide means for additional low-cost high-tech data sharing. This expanded system will provide more State agencies with access to information that will help them enforce their statutes. For example, the DIR registers all garment contractors and farm labor contractors. If the DIR used the same numbering system as the EDD, the EDD could run a computer

match to determine whether any of the garment or farm labor contractors were not registered as employers.

Further, consideration should be given to requiring all State agencies to use the Federal Employer's Identification Number. This would allow for easy access of a significant portion of available information and ensure uniformity.

Recommendation #5: The Governor and the Legislature should provide ways for nontaxing agencies to obtain and use greater amounts of information currently available only to tax agencies.

DIR and CSLB deputies are not able to obtain and fully use certain tax-related information from taxing agencies. This severely hinders their ability to use information provided through sharing agreements with taxing agencies. For example, CSLB and DIR deputies' access to EDD's quarterly files on employees' wages is limited. If DIR deputies had full access to these tax files, they could obtain sufficient information to complete their cases and write citations with minimal field work. Within legal constraints and with adequate controls to ensure confidentiality, these agencies should have greater access to that information once it has been determined that a violation has occurred.

Recommendation #6: Additional management emphasis should be placed on ensuring that leads are shared and used and that field office supervisors establish and maintain greater cooperation and coordination between offices.

Greater cooperation and coordination will allow for sharing more information and greater use of shared information. In addition, it may help the offices respond to leads in a more timely manner. For example, the three agencies involved in the ICE agreement currently require that leads be sent from the field to the agency's headquarters. From there, they are transmitted to the other agency's headquarters and then dispersed to the field. This process often takes several months and thus the leads may be too old to use. With additional management emphasis on following-up on leads and greater field office coordination, more value will be obtained from the leads because they will be received in a more timely manner.

If the leads still cannot be handled in a timely manner, the agencies should consider transmitting the leads directly to the local field offices of the other agencies, with copies (or summaries) transmitted to headquarters. This could be pilot tested to determine its benefits. This approach could prove to be beneficial because (1) the leads would be more timely; (2) the receiving agency would know who to contact for additional information; and (3) the field staff in each agency would become familiar with staff from other agencies. This familiarity would result in a greater understanding of the other agencies' needs as well as knowledge of the value of sharing information. Thus,

the leads would be more valuable and there would be more sharing of information.

#### STAFFING AND PERSONNEL MANAGEMENT

Recommendation #7. On a test basis, auditors and investigators from the State's taxing and enforcement agencies should be trained on the basic requirements of other agencies and, where appropriate, be given authority to enforce the other agencies' laws. When conducting an audit, they should conduct minimum tests of compliance with other agencies' requirements. If the test is successful, this should be expanded to all auditors and investigators.

When an auditor or investigator is conducting field work for his or her own agency, he or she will often come upon information of value to other agencies. Often, however, the auditor or investigator does not have the time, interest, or training to identify or obtain the additional information needed by the other agency. For example, EDD auditors who have found cash-pay violations could cite based on their own laws as well as for violation of DIR's Labor Code. In those EDD field offices that maintained a working relationship with their DIR counterparts, we found that they were in fact providing sufficient information to the DIR deputies to write the citation, and we believe that with minimal training and technical support from the DIR as needed, they could write the Labor Code citation. The ability to do this is especially critical in those cases when there might be a problem with the DIR deputies obtaining tax information from the EDD.

Therefore, auditors and investigators in each State taxing and enforcement agency should be given training on areas traditionally audited or investigated by other agencies. Additionally, each agency's audit program should be modified to include a limited number of new audit steps that would identify potential areas of noncompliance of concern to other taxing agencies. Guidelines should be developed to ensure that auditors do not abuse these steps or spend too much time in these areas. In implementing this recommendation, care must be taken to ensure that the auditors and investigators do not exceed their statutory authority.

As an example, if an FTB auditor had a basic understanding of the information reported on the EDD's and the B of E's quarterly returns, the FTB auditor could quickly review these returns for reasonableness. If a taxpayer who obviously had employees and was selling at retail stated that he or she did not file with either the EDD or the B of E, the FTB auditor could notify those agencies of the need for an audit of the organization.

Recommendation #8: The Department of Industrial Relations should review the need to increase the number of audit staff

employed in the Labor Standards Enforcement Division to enable it to conduct more thorough audits of cash-pay violations. Additionally, division staff should receive training in "reconstruction" methods of auditing.

Currently, the DIR employs few auditors; consequently, the department is frequently limited in the overall assessment it can levy against violators since its investigators are not trained in necessary auditing techniques. To determine the appropriate number of auditors the DIR should employ, it should conduct a staffing analysis and determine if a certain number of its current positions could be reclassified into one of the State auditor classifications, preferably one that combines audit with investigative skills. These individuals should be provided training in investigative techniques applicable to the enforcement of labor laws to enable the district offices to use them in broader capacities.

"Reconstruction" is an accepted approach to auditing frequently used by Board of Equalization auditors to establish actual sales and the sales tax due. The same methodology could be used by the DIR when investigating cash-pay transactions as a means of determining the number of employees necessary to either construct the homes, manufacture the garments, serve the patrons in restaurants, or produce the sales reported or that are visible. The technique has withstood the test of numerous court cases.

Because various State taxing agencies already use this methodology, the resources and expertise to provide DIR staff this training are already available within the State.

Recommendation #9. The Governor and Legislature should reevaluate the staffing levels needed by audit, investigative, and enforcement units.

Audit staffing has remained relatively constant for the FTB and the B of E and has been significantly reduced for the EDD over the past five years. At the same time the underground economy appears to be growing rapidly.

To evaluate and correct this problem, the Legislative Analyst and the Department of Finance should independently evaluate the value of additional audit, investigative, and enforcement staff considering the extremely high benefit-cost ratios. Additional staffing should be approved where the benefit-cost ratios provide the State substantial returns. Irregardless of the benefit-cost ratio, a certain level of staff effort should work in less productive audit areas to ensure some field presence and encourage voluntary compliance.

## OPERATIONS AND METHODS

Recommendation #10: The EDD, FTB, B of E, and DIR should each develop a policy, associated goals, and measurable objectives for improving self-assessment of increased voluntary compliance resulting from their activities. These policies, goals, and objectives should be based on the respective agency's responsibilities and the broader goals and objectives of its sister taxing and enforcement agencies.

Although it is difficult to measure voluntary compliance, it is obvious that more must be done to encourage it. Possible actions include additional services to help those individuals who are trying to comply, as well as greater enforcement actions against those who do not. In addition, the Governor and the Legislature should authorize a project to measure the level of voluntary compliance with the different State taxes.

The California Occupational Safety and Health Administration (Cal/OSHA) includes a consultation service which provides on-site consultation to employers. This service, provided at the employer's request, assists them in voluntarily complying with Cal/OSHA safety and health regulations. A similar consultation service assisting businesses could be provided through existing State programs and resources. For example, on a test basis the Department of Commerce staff in the Small Business Development Center program could be provided with training and a listing of designated contacts for referrals. If this test project was found to help employers comply with the State's requirements, it could be expanded.

Recommendation #11: The Legislature and the Governor should reevaluate the criteria currently used to select potential violators for audit to give greater weight to increasing voluntary compliance.

Because the Legislature has mandated that (1) the FTB and B of E select audits based primarily on potential for dollar recoveries, and (2) the CSLB direct its deputies to work only on consumer complaints, these agencies are, in effect, precluded from directing significant effort towards maximizing voluntary compliance.

The Legislature and the Governor should reconsider these mandates based on their significant impact on other types of enforcement and particularly on the foregone opportunities to increase voluntary compliance.

## ENFORCEMENT

Recommendation #12: The Board of Equalization, Department of Industrial Relations, Employment Development Department, and Contractors' State Licensing Board should increase their level of prosecutions and each develop an expanded program to actively publicize cases in which violators have been successfully

prosecuted. The use of the media should also include an expanded public education program.

Expanded use of print and electronic media will help educate the public to the consequences of participating in the underground economy while also signaling that the State is aggressively investigating and penalizing those who choose to violate State tax and labor laws. To successfully achieve these results, each agency should work closely with the media to determine how to provide information which fits its needs.

Recommendation #13: The Governor and the Legislature should encourage the U.S. Congress to create guidelines for determining whether an individual is acting as an employee or as an independent contractor.

Because of the ambiguities in current rules for determining whether an individual is an employee or an independent contractor, and because the same rules should apply at the State level and the federal level, the Governor and the Legislature should encourage the California delegation to the U.S. Congress to provide greater direction in this area.

Recommendation #14: The Governor and the Legislature should authorize a "graduated" penalty system where appropriate to provide more severe penalties for repeat violators.

At this time it is cost-effective for many individuals and businesses to continuously play "audit roulette." They will take their chances of getting caught and consider the potential penalties as part of the cost of doing business. To provide a disincentive for this habitual type of tax evader, all State penalties should be reviewed and graduated penalties should be established where appropriate. For example, larger penalties should be available in cases of neglect, fraud, or chronic misstatements.

These graduated penalties should increase at a rate sufficient to make it unprofitable to try to cheat a second time. Penalties for repeat violations could include automatic suspension of licenses (for those businesses that are licensed), trebled fines, and provisions for felony prosecutions instead of misdemeanors.

Recommendation #15: State agencies should develop a system of selective "follow-up" visits to insure that previous violators are still in compliance with the law.

To insure that violators do not become repeat offenders, the State agencies should incorporate a system for selected reinspection. The reinspection should be of a limited number of entities, but a sufficient number to ensure that violators know that there is a chance of being caught if they cheat again. Further, these reinspections should be unannounced. This

project, coupled with larger penalties for repeat offenders, will be an effective deterrent in that it will make it extremely risky to not come into compliance, especially after being inspected once. Thus, voluntary compliance will increase.

Recommendation #16: State tax and enforcement agencies should consider expanded use of automatic, computer-generated citations based upon work done by other agencies.

As stated in Chapter V, one Labor Standards Enforcement field office of the DIR automatically issues citations to unlicensed contractors cited by the CSLB after the deputy determines that the unlicensed contractor had employees. Similarly, the FTB will automatically issue an assessment for taxes due from nonfilers, or if the FTB discovers additional income not reported by a taxpayer. Expansion of this method should be considered.

All DIR field offices could adopt this procedure. Similarly, the EDD and the DIR should evaluate the feasibility and benefits of issuing automatic citations based on each other's work. The ability to cite automatically may require a small amount of work by the initial agency, such as having the CSLB deputy determine how many employees the cited unlicensed contractor had (see Recommendation #7).

Recommendation #17: The EDD, the DIR, and the FTB should initiate a trial project to determine the extent of loss to the State because of employees receiving cash-pay who are also receiving unemployment insurance and/or are not paying income tax on their cash-pay income. Based on the results of this trial project, the three agencies should consider additional enforcement in this area.

To accomplish this, the three agencies should establish a system to follow-up on a sample of employees who received cash to ensure that they were not also receiving unemployment insurance benefits. This test should be expanded as necessary to ensure that the employees were not inappropriately receiving other benefits such as welfare, Medi-Cal, etc. In addition, the FTB should conduct desk audits on these individuals to ensure that they claimed their cash income on their individual tax returns. While some of these tests may not be cost effective at first, we believe they are necessary to: 1) help determine the extent of State loss due to cash-pay, and 2) provide further notice to participants in the underground economy that the State is taking a more aggressive position in this area.

Recommendation #18: The Legislature and Governor should increase the penalties for employers who do not carry workers' compensation insurance.

The penalty for not having a workers' compensation insurance policy should be parallel to the penalty for not

paying unemployment insurance. Specifically, employers should be assessed an amount equal to the rate they would have paid to keep a policy in force. Thus, if an employer had an employee for two years without a policy, that employer should be assessed two years of premiums plus interest. These funds should be deposited into the State's uninsured employer fund.

Recommendation #19: The State should increase the proportion of cases developed for criminal prosecution and work closely with district and city attorneys to ensure that these cases are prosecuted.

The State's audit, investigative, and enforcement units should increase efforts to bring criminal cases to trial. Although the district and city attorney's hesitancy to handle cases at this time may make this difficult, we found that most field representatives had not even tried to take cases to court.

In our discussions with district and city attorney representatives, we found that while they were hesitant to take the State's cases, they would accept them if the cases were complete, fully documented, and properly explained by the auditor. Because auditors are usually evaluated based on the number of closed cases, there is an incentive to not devote time to taking cases to trial. Thus, we believe that it would be appropriate to include the number of cases prosecuted as part of the evaluation of field offices.

To ensure an aggressive enforcement program, the State must work closely with, and encourage district and city attorneys to prosecute State cases. Since most violations are misdemeanors with no constituency to complain if these cases are not handled, they usually are a low priority. Thus, the State agencies must ensure that their cases are relatively easy for the attorneys to handle and have some publicity value.

The Legislature could also support district and city attorneys through new statutes that would allow them to recover costs of investigation and prosecution directly from the defendant. Other support might include the direct funding of special units in larger areas to prosecute State cases.

Recommendation #20: The Legislature should amend current statutes to require that any contracts using any form of State monies be awarded based upon criteria that includes an assessment of the contractor's past compliance with tax and labor laws, particularly cash-pay violations.

Generally, government contracts are awarded to the "lowest responsible bidder." However, there are no laws or guidelines for defining "responsible." Consequently, contracts are awarded almost solely on the basis of price, even though the low bid may be possible only through use of cash-pay arrangements with

workers or through other willful and intentional illegal practices.

Although restrictions on the criteria for awarding contracts funded with State monies would represent only a small percentage of total projects, there are substantial dollars involved. Additionally, if the successful contractor is discovered to be violating tax and labor laws during the course of the project, the State should withhold funds from the awarding entity. It is the intent of this recommendation to refer to severe violations of tax and labor laws, particularly where there has been repeat violations.

## APPENDIX A

### STATE AGENCIES STUDIED

During this study we worked extensively with five State agencies--the Department of Industrial Relations, the Employment Development Department, the Franchise Tax Board, the Board of Equalization, and the Contractors' State License Board. A brief synopsis of each agencies' responsibilities follows:

#### Department of Industrial Relations

The Department of Industrial Relations (DIR) is responsible for protecting the workforce, improving working conditions, and advancing opportunities for profitable employment. Within this broad range of responsibilities, the DIR enforces the labor code through investigations, citations, hearings and criminal prosecutions.

The DIR does not collect taxes; rather, it is concerned about cash-pay because it circumvents the rules relating to the employer-employee relationship. The California Labor Code establishes numerous rules regarding the employer-employee relationship such as minimum pay, overtime regulations, and requiring that employers provide pay slips showing all deductions from an employee's wages. The practice of cash-pay adversely affects these and other requirements.

The DIR does not have a significant proactive enforcement program to search for employers engaging in cash-pay. Instead, it generally waits for individuals to come in and complain that their employer has been paying in cash or has not made proper deductions or provided a pay slip. However, since the employees are often co-conspirators, they will seldom come forth, and are even less likely to testify. The DIR also receives tips from competitors, unions, or other third parties. When the DIR finds a cash-pay violation, it can issue a citation and fine the employer \$100 per employee for each pay period the employee was paid without the appropriate pay records. The DIR, however, has a number of obstacles in enforcing these citations. Since the employees are often co-conspirators, it may be difficult to obtain witnesses. Further, if the employer does not pay the citation, the DIR must take the employer to court and sue for judgement. However, if the DIR is pursuing wage claim cases (where an employer failed to pay an employee) its first priority is to get the back wages paid. (Interestingly, if the DIR must attach the employer's property and pay the wages directly to the employee, the DIR will not withhold taxes).

#### Franchise Tax Board

The Franchise Tax Board (FTB) administers the personal income tax and the bank and corporation tax laws, along with several smaller programs. It collected over \$12.5 billion of

State revenue. In fiscal year 1983-84 its filing enforcement program was responsible for net assessments of \$223 million at a cost of about \$6 million while its audit activities resulted in net assessments of \$535 million at a cost of less than \$32 million. Although the FTB is responsible for over \$10 billion of State revenue, 80 percent of these funds are actually collected by the EDD through withholding tax.

The FTB refers to the underground economy in terms of the "tax gap." The tax gap is defined as the difference between what is legally owed in taxes and what is voluntarily paid. For 1981, the FTB estimated the tax gap on State income tax alone at about \$1.7 billion.

The Franchise Tax Board has been actively working on ways to control the tax gap. It works closely with the Internal Revenue Service (IRS) and has agreements to share data with its federal counterpart as well as with the State Employment Development Department, the Board of Equalization, and other entities.

The FTB reviews, to some extent, every tax return it receives. Once it receives the tax returns, it categorizes, processes, and files them. It then mathematically verifies most of the returns. In fact, the FTB mathematically verified almost 11 million personal income tax returns during fiscal year 1982-83.

Based on certain criteria, the FTB screens and categorizes tax returns according to audit potential. The FTB then audits selected returns, confirming the income and deductions reported by the taxpayers. While the FTB has not established any special audit projects to specifically deal with the cash-pay problem, many of their projects touch upon that area. For example, the FTB requires informational statements (Form 599), which are similar to wage statements (Form W-2), for nonemployee payments over \$600 per year. Thus, if a contractor issues a Form 599 for payments to a subcontractor, the FTB gets a copy and can match it with the worker's tax return. If the FTB finds that a contractor, or any other employer, failed to issue a Form 599, the FTB can impose penalties.

#### Board of Equalization

The Board of Equalization (B of E) administers 13 programs; the largest of which is the sales and use tax program. This tax is imposed on retailers for the privilege of selling tangible personal property in California. This tax may be passed on to the consumer and almost always is. For fiscal year 1983-84, the B of E collected \$13.7 billion, of which \$11.6 billion was sales and use tax.

The B of E does not directly address the cash-pay issue because payments for labor have no sales and use tax

consequence. It is concerned, however, with the accurate reporting of sales and directs its enforcement efforts toward ensuring that all sales are reported and that correct allocations are made between taxable and nontaxable sales.

During fiscal year 1983-84 the B of E conducted over 20,000 audits of sales and use taxes which resulted in \$245 million of tax deficiencies. This amounted to a return of \$274 for each hour of audit effort.

#### Employment Development Department

The Employment Development Department (EDD) is an employment services agency which also has a taxing function. Its objectives include person-power planning, training, employee placement, and processing unemployment and disability insurance payments, as well as collecting employer and employee contributions to unemployment insurance, disability insurance, and withheld State income tax.

The EDD is concerned about cash-pay transactions because they can adversely affect the Unemployment Insurance Fund and the Disability Insurance Fund in two ways. If cash-pay transactions are not reported, the taxes are not collected for these funds. In addition, since there is no record of employment, the employee may file for benefits from these funds.

The EDD's highest priority leads are based on obstructed claims. When an individual applies for Unemployment Insurance (UI) or State Disability Insurance (SDI) benefits from EDD, they must list their previous employers. The EDD then verifies that those employers reported the wages and contributed into the UI and SDI funds. If the employer did not report the wages (or underreported them), the computer issues an obstructed claim notice.

The EDD also initiates investigations based on tips from other State agencies or from individuals. In addition, the EDD has access to informational returns (Form 599) through the FTB, and can screen them to see whether further investigation might reveal that an employer has inappropriately classified an employee as a subcontractor. In each of these cases, there is potential for uncovering cash-pay.

The leads received by headquarters are sent to the appropriate district office where they are prioritized. Since they have more work than they can handle, the EDD auditors complete their mandatory work, such as clearing obstructed claims, then prioritize other work based on potential recovery.

If an auditor comes across a major problem, or believes that there may be a problem but cannot obtain information or witnesses, the auditor can request assistance from EDD's Investigation Division. Most of the Investigation Division's

work is directed toward U.I. and S.D.I. fraud, but it also runs an Underground Economy Detection Program to deter employers who may contemplate or who are actually involved in evading payment of State payroll taxes. This program is staffed by six investigators and two tax auditors who use a variety of audit, surveillance and search techniques.

#### Contractors' State License Board

The Contractors' State License Board (CSLB) is responsible for licensing and regulating contractors within California. The CSLB has no direct tax or employer-employee responsibilities, although it can discipline licensees for violating labor laws. We are including the CSLB in our study because the construction industry is known for making extensive use of cash-pay.

The CSLB enforcement function is directed at protecting the consumer from poor contracting, and thus most of its workload comes from consumer complaints. If, during its resolution of a consumer complaint, the CSLB believes that the contractor is not properly withholding or remitting taxes or unemployment insurance, is violating the labor code, or if the CSLB comes across other information that it feels should be shared with other State agencies, it can forward that information to the appropriate agency. Similarly, the CSLB receives leads from other agencies which have noted irregularities in contractors' practices. The CSLB has about 85 field deputies, including three individuals who make up its special investigations unit.

APPENDIX B

MEMBERS OF THE BLUE RIBBON ADVISORY COMMITTEE  
ON THE UNDERGROUND ECONOMY

The following individuals provided the Commission with insight to the issues involved with the underground economy. These individuals participated in three committee meetings and provided additional assistance individually as needed. However, the findings and recommendations contained in this report are those of the Commission on California State Government Organization and Economy. Although these findings and recommendations were discussed with the Committee, the committee members do not necessarily endorse each of them.

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