



Joint Enforcement Strike Force On the Underground Economy

2009 Report

**Employment Development Department
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This report was prepared by the Tax Branch of the California Employment Development Department

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TABLE OF CONTENTS

EXECUTIVE SUMMARY	ii
JESF PROGRAM OVERVIEW	1
BACKGROUND	1
The Underground Economy	1
Joint Enforcement Strike Force	2
Employment Enforcement Task Force	3
SUMMARY OF INFORMATION REQUIRED BY SECTION 329 (d) OF THE CALIFORNIA UNEMPLOYMENT INSURANCE CODE	4
Blatant Violations and Noncompliance	4
Employment Enforcement Task Force Program Results	4
Criminal Tax Evasion Program Results	4
Publicity	5
Telephone Hotline	5
Information Sharing	5
Cooperation	6
Recommendations for Statutory Changes	6
ATTACHMENT A – Blatant Violator Cases	7
EETF Blatant Violator Cases	7
JESF Joint Criminal Prosecution Cases	8

EXECUTIVE SUMMARY

This report provides a summary of activities and outcomes from the Joint Enforcement Strike Force (JESF) on the Underground Economy in accordance with §329(d) of the Unemployment Insurance Code (UIC).

In October 1993, Executive Order W-66-93 established the JESF to combat the underground economy by pooling resources and sharing data among the State agencies charged with enforcing licensing, labor, and payroll tax laws.

On January 1, 1995, §329 was added to the UIC, which placed the provisions of the Executive Order into law. The JESF members are the Employment Development Department (EDD), which is the lead agency, Department of Consumer Affairs (DCA), Department of Industrial Relations (DIR), and the Department of Insurance (DOI). The Franchise Tax Board (FTB), Board of Equalization (BOE), and Department of Justice (DOJ) are not part of the administration but are encouraged to participate in the strike force.

The Underground Economy affects businesses and workers throughout the State of California. Businesses that participate in the underground economy undercut their competitors by paying cash to avoid taxes and other required payments such as workers' compensation insurance and unemployment insurance. This allows them to gain a competitive advantage over other businesses that report and pay their fair share. When a business operates in the underground economy, its workers may have difficulty qualifying for workers' compensation insurance coverage, state disability insurance, or unemployment insurance benefits when otherwise eligible. These employers may also fail to comply with labor and worker safety laws.

The goals of the JESF are to:

- Eliminate unfair business competition.
- Protect workers by ensuring that they receive all benefits to which they are entitled by law relating to wages and hours, health and safety, and income replacement.
- Protect the consumer by ensuring that all businesses are properly licensed and that they adhere to the State's consumer protection regulations.
- Reduce the burden on law-abiding citizens and businesses by ensuring that all businesses and individuals comply with the State's licensing, regulatory, and payroll tax laws.
- Reduce the tax gap by increasing voluntary compliance with the State's payroll tax laws to maximize the State's General and Special Fund revenues.

JESF PROGRAM OVERVIEW

The Employment Enforcement Task Force (EETF) was created to serve the purpose of the JESF. The goal of EETF is to identify and bring into compliance those individuals and businesses participating in the underground economy that are in violation of payroll tax, labor, and licensing laws. The EETF operates primarily through teams of Joint Enforcement Agents from EDD and DIR (Division of Labor Standards Enforcement (DLSE)). In addition DCA; including Contractors State Licensing Board (CSLB), Bureau of Automotive Repair (BAR), and Bureau of Security and Investigative Services, and DOI participate on EETF teams. Leads are received from other agencies, individuals, businesses, and calls to the established toll-free hotline. These leads are researched through various databases to determine if there are active licenses as required, workers' compensation insurance coverage, and registration with EDD. When there is a reasonable belief that there is noncompliance with licensing, labor or payroll tax law, agents from each participating agency conduct joint inspections of work sites of businesses to determine if there is cause for further enforcement action.

In 2009, EETF referrals to EDD's audit program resulted in 31 fraud determinations, unreported wages of \$116.2 million, and 4,092 unreported workers, and assessments totaling \$17.9 million. As part of these joint enforcement efforts, DLSE issued 295 labor code citations totaling \$4.1 million.

Collectively, these efforts ensure that workers receive the benefits they are entitled to by law, provide a deterrent to employers who may consider participating in the underground economy rather than voluntarily complying, and provide additional General Fund and special fund revenues through subsequent collection of liabilities for each agency.

In addition, EDD has a Criminal Tax Evasion Program (CTEP) that focuses on the most serious payroll tax reporting violations committed by California employers, and works with JESF partners to investigate and criminally prosecute these most egregious violators. The CTEP partners with DOI on almost all of its criminal prosecutions in filing joint charges, and sometimes DIR DLSE is involved as well.

BACKGROUND

The Underground Economy

"Underground economy" is a term that refers to those individuals and businesses that deal in cash and/or use other schemes to conceal their activities and their true tax liability from government licensing, regulatory, and tax agencies. Underground economy is also referred to as tax evasion, tax fraud, cash pay, and payments under-the-table or off-the-books.

The actual size of the underground economy is difficult to measure. In February 1995, American Demographics estimated for the Internal Revenue Service (IRS) that there was over \$1 trillion in unreported income in the United States. The General Accounting Office (GAO), the investigative arm of the United States Congress, conducted a study of tax year 2001 and found the federal tax gap to range from \$312 billion to \$353 billion. A February 2005 report, *California's Tax Gap*, prepared by California's Legislative Analyst's Office, estimates California's income tax gap to be \$6.5 billion.

Barron's Online featured the article, *Going Underground*, January 3, 2005. This article states in part: 'America has two economies, and one is flourishing at the expense of the other. First, there's the legitimate economy, in which craftsmen are licensed and employers and employees pay taxes. Then there's the fast-growing underground economy, where millions of workers are paid off-the-books, their

incomes largely untaxed. The best guess as to the size of the output of this shadow economy is about \$970 billion or nearly 9 percent that of the real economy. It should soon pass \$1 trillion.'

A 2002 report, *Workers Without Rights*, published by the Economic Round Table (a nonprofit, public-policy research organization in Los Angeles) states at least 28 percent of the workforce in Los Angeles County is engaged in the underground economy. This translates into \$1.1 billion in lost payments to the Social Security Administration, workers' compensation insurance premiums, and unemployment insurance contributions per year.

Reports on the underground economy indicate it imposes significant burdens on: (1) revenue needed to fund critical state programs, (2) businesses that comply with the law, and (3) workers who lose benefits and other protections provided by State law when the businesses they work for operate in the underground economy.

When businesses operate in the underground economy, they gain an unfair, competitive advantage over businesses that comply with various labor, licensing, and payroll tax laws. This causes unfair competition in the marketplace and forces law-abiding businesses to pay higher taxes and expenses.

Workers of noncompliant businesses are also affected. Their working conditions may not meet the legal requirements, which can put them in danger. Their wage earnings may be less than those required by law, and benefits they are entitled to can be denied or delayed because their wages are not properly reported.

Consumers can also be affected when contracting with unlicensed businesses. Licensing provisions are designed to ensure minimum levels of skill and knowledge to protect the consumer.

The ultimate impact of the underground economy is erosion of the economic stability and working conditions in this State.

Joint Enforcement Strike Force

On October 26, 1993, the JESF was established by Executive Order W-66-93. The purpose of JESF is to: enhance the development and sharing of information necessary to combat the underground economy; improve the coordination of enforcement activities; and develop methods to pool, focus, and target the enforcement resources of all members in support of the enforcement activities of individual agencies.

Subsequent legislation, Senate Bill (SB) 1490 (Chapter 1117, Statutes of 1994), codified the Executive Order by adding §329 to the UIC and established a January 1, 2000 sunset date. SB 319 (Chapter 306, Statutes of 1999) extended the sunset date to January 1, 2006. In 2004, SB 3020 (Chapter 685, Statutes of 2004) removed the sunset provision. Member agencies include the EDD, DIR, DCA, DOI (added by Assembly Bill 202 effective January 1, 2002) and the Office of Criminal Justice Planning (OCJP). The FTB, BOE, and DOJ are not part of the member agencies but are encouraged to participate in the strike force. The EDD Director is the chairperson.

Employment Enforcement Task Force

The EETF program was created to serve the purpose of the JESF. Participating agencies include EDD, DIR, DLSE, CSLB, BAR, Bureau of Security and Investigative Services, and DOI. The goal of EETF is to identify and bring into compliance those individuals and businesses participating in the underground economy that are in violation of payroll tax, labor, and licensing laws. Since its inception, EETF has focused on the construction, automotive repair, garment manufacturing industries, bars, restaurants, nightclubs, furniture manufacturers, and other industries where on-site inspections can be done. Although EETF focuses on industries known to have a high degree of noncompliance, investigations of businesses not included in the target group are also conducted when underground economy activity is suspected.

The EETF agents from each agency jointly conduct on-site investigations of businesses by interviewing owners, managers, and workers to determine if businesses are in compliance with payroll tax, labor, and licensing laws. To minimize the disruption of compliant businesses, EETF conducts investigations only if there is reasonable belief of violations of the UIC, Labor Code, Business and Professions Code, and/or the California Insurance Code.

A system for identifying businesses that are suspected of operating in the underground economy was designed and implemented. There are five major sources of leads: telephone hotline numbers, internet webpage referrals, other government agencies, industry sources, and leads developed by EETF investigators.

In addition, EDD has the CTEP that focuses on the most serious payroll tax reporting violations committed by California employers, and works with JESF partners to investigate and prosecute these most egregious violators. The CTEP partners with DOI on almost all of its criminal prosecutions by filing joint charges, and sometimes with other member agencies as well. The CTEP (as sworn peace officers) participates on employer/workers' compensation task forces in Orange, Riverside, San Bernardino, San Diego, Ventura, and Central Valley counties to identify and prosecute employer fraud, including workers' compensation, payroll tax, personal income tax, prevailing wage, and licensing violations. The CTEP partners with DOI, DIR, and DCA to do joint surveillance, serving of search warrants, and collectively work with the California Office of the Attorney General and/or the Department of Justice to file joint criminal complaints.

The JESF members recognize the importance of combining enforcement activities with an ongoing educational program. Member Agency staff conduct outreach presentations to business and labor organizations throughout the State and to representatives of local government agencies. These presentations inform a large number of people about JESF activities and continue to be an excellent source for leads, as well as providing education to the employer community on how to comply with each agency's laws.

For examples of activities related to JESF efforts, please refer to Attachment A.

SUMMARY OF INFORMATION REQUIRED BY SECTION 329 (d) OF THE UNEMPLOYMENT INSURANCE CODE (UIC)

This section includes information that is mandated by §329(d) of the UIC which states: “The report shall include, but not be limited to, all of the following.”

Blatant Violations and Noncompliance

UIC §329(d)(1) states: “The number of cases of blatant violations and noncompliance with tax and cash-pay laws identified, audited, investigated, or prosecuted through civil action or referred for criminal prosecution” shall be reported.

2009 EETF Program Results

Joint Inspections	388
EDD Audit Referrals	388
EDD Audits Completed	360
Fraud Penalty Cases	31
EDD Audit Assessments	\$17,922,866
EDD Average Audit Assessment	\$49,786
Previously Unreported Wages	\$116,249,769
Previously Unreported Employees	4,119
DLSE Labor Code §226* Citations	86
DLSE Labor Code §226 Citation Amounts	\$2,936,250
DLSE Labor Code §3700* Citations	185
DLSE Labor Code §3700 Citation Amounts	\$1,019,394
Other DLSE Labor Code Citations	24
Other DLSE Labor Code Citation Amounts	\$151,250

*226 = No statements of earnings and deductions

*3700 = No workers’ compensation insurance

DCA and DOI do not keep segregated statistics for joint enforcement efforts and thus, are not reported in this report.

2009 EDD Criminal Tax Evasion Program Results

Enforcement Activity	Number of Cases	Dollar Amount of Tax Liability
Payroll Tax Evasion Cases in Progress	158	\$44,454,343
EDD Criminal Complaints Filed	18	\$2,611,585
EDD Criminal Prosecutions Completed	20	\$4,004,069

Statistics for other member agencies on joint prosecutions is not available as these agencies do not segregate results between JESF and non-JESF prosecutions.

Publicity

UIC §329(d)(2) states: “Actions taken by the strike force to publicize its activities” shall be reported.

- ❑ EDD Web Page
- ❑ Joint and separate educational seminars
- ❑ Press Releases
- ❑ Employer Newsletters
- ❑ EDD Information Sheets

The JESF members have not tracked specific incidences and benefits derived from joint efforts regarding publicity.

Internet Sites

The EDD’s Underground Economy Operations (UEO) Web page address is:

http://www.edd.ca.gov/payroll_taxes/underground_economy_operations.htm#joint_enforcement_strike_force.

Telephone Hotline

UIC §329(d)(3) states: “Efforts made by the strike force to establish an advertised telephone hotline for receiving referrals from the public” shall be reported.

UIC §329 of the Unemployment Insurance Code empowers JESF to establish procedures for soliciting referrals from the public, including, but not limited to, an advertised telephone hotline.

In an effort to improve customer service and make it easier for the public to report violations of payroll tax, labor, and licensing law, JESF established a toll-free hotline in 1997. The number is (800) 528-1783. This number can be reached 24 hours a day, 7 days a week. Outside of business hours, or when the line is engaged, an automated voice mail system answers the phone and records messages with lead information. In 2009, the JESF toll-free hotline received 415 contacts from informants wishing to provide information on potential underground economic activities. The hotline is marketed on EDD’s public web page under “Report Fraud,” during presentations given by EDD’s Taxpayer Education and Assistance Program, and by other EDD staff when appropriate. Additionally, the JESF Hotline and other JESF contact information is publicized on several EDD Information Sheets available to the public via the internet and at EDD Public Service Counters.

Information Sharing

UIC Section 329(d)(4) states: “Procedures for improving information sharing among the agencies represented on the strike force” shall be reported.

Underground economy businesses constantly develop new schemes to avoid detection of their illegal activities. As these new schemes are identified, information regarding the schemes is shared with member agencies, business associations, and labor organizations. There is an ongoing need for JESF

staff to be aware of the various types of schemes used in industries prone to underground economy activity. This knowledge facilitates the development of detection and enforcement techniques necessary to stop the illegal activities. Information is shared as follows:

- ❑ On-the-job experiences
- ❑ Informal ad-hoc joint management meetings
- ❑ Semi-annual management meetings with member agencies
- ❑ Memoranda of Understanding

Cooperation

UIC §329(d)(5) states: “Steps taken by the strike force to improve cooperation among participating agencies, reduce duplication of effort, and improve voluntary compliance” shall be reported.

Cooperative efforts among JESF member agencies continue to evolve and grow stronger. The operations of EETF have forged closer ties and improved coordination of enforcement activities among EDD, DIR, and DCA. Among DCA programs, the CSLB, BAR, and the Bureau of Security & Investigative Services have been active participants in EETF operations. These partnerships and joint operations have improved program results in all the participating agencies, thereby providing the agencies with incentives for continued cooperation and expansion of existing relationships.

During the past several years, Memoranda of Understanding have been developed to facilitate the sharing of information and databases across enforcement partner agencies and to enhance cooperation and joint enforcement of labor, tax, and licensing laws.

Strides have been made in increasing cooperation among all licensing, labor law, and payroll tax enforcement agencies. A coordinated effort now exists that involves not only JESF member agencies, but also other local, federal, and State entities. Cooperative efforts are expected to continue and grow as the operations of JESF become more successful and as other agencies become more aware that cooperative efforts produce successful results.

Recommendations for Statutory Changes

UIC §329(d)(6) states: “Recommendations for any statutory changes needed to accomplish the goals described in paragraph (7) of subdivision (c)” shall be reported.

UIC §329(a) includes as one of the participating JESF members, the OCJP. The OCJP was defunded in 2005. It is recommended that §329(a) be amended to remove OCJP from the listing of JESF member agencies.

Blatant Violator Cases

The following examples of blatant violation cases detected by JESF include the most flagrant cases where schemes were used by businesses to avoid payroll tax, labor, insurance, and licensing laws; and where EDD found fraud or intent to evade payment of payroll taxes:

EETF Blatant Violator Cases

- An EDD EETF Agent and Deputy Labor Commissioner of DLSE inspected a construction site. The lead submitted to EDD alleged that the employer was paying employees in cash. Even though the employer had workers for five years, the entity was not registered with EDD. At the time of the inspection, DLSE issued three citations totaling \$6,300. Subsequent EDD audits revealed that there were two entities via a Unity of Enterprise and both businesses have been out of compliance for five years. The EDD tax auditor determined that, combined, the businesses failed to report subject wages of \$1,092,000 paid to 15 unreported employees. The employer was assessed for the two businesses \$204,381 for unpaid payroll taxes, penalties, and interest, including fraud penalties.
- An EDD EETF agent and an Investigator with the CSLB conducted an inspection of a construction job site. The inspection was initiated due to an allegation submitted to EDD alleging the employer was paying employees in cash. The employer is registered with EDD, but was under-reporting the number of workers and the total amount of the payroll. During the inspection, there were 10 employees working and 17 workers identified. A subsequent EDD audit revealed that the corporation had been out of compliance for seven years. The EDD tax auditor determined that the employer failed to report subject wages of \$4,448,750 paid to 20 unreported employees. The employer was assessed \$1,037,397 for unpaid payroll taxes, penalties, and interest, including fraud penalties.
- An EDD EETF agent and a DLSE Investigator conducted an inspection of a job site of a painting company. The lead was self-generated by the EETF Agent. The employer was registered with EDD at the time of the inspection, but was underreporting the number of workers and the amount of the payroll. The DLSE Investigator issued a citation for \$6,000 for six workers working without a valid workers' compensation policy. A subsequent EDD audit revealed that the employer had been out of compliance for 15 years. The EDD tax auditor determined that the employer failed to report subject wages of \$1,972,622 paid to six unreported employees. The employer was assessed \$878,691 for unpaid payroll taxes, penalties, and interest, including fraud penalties.
- An EDD EETF agent, Deputy Labor Commissioner of DLSE, and police officers from the Los Angeles Police Department conducted an inspection of a cocktail lounge. The inspection was initiated as a result of EDD receiving a letter alleging the employer had been paying employees in cash for six years and not reporting workers to EDD. The employer was not registered with EDD at the time of the inspection. At the business, the team observed 13 employees. The DLSE Investigator issued a citation for \$13,000 for 13 employees working without a valid workers' compensation insurance policy and \$5,500 for paying worker in cash without a proper deduction statement. A subsequent EDD audit revealed that the employer had been out of compliance for six years. The EDD tax auditor determined that the employer failed to report subject wages of \$1,144,315 paid to 13 unreported employees. The employer was assessed \$215,211 for unpaid payroll taxes, penalties, and interest, including fraud penalties.

- An EDD EETF agent and a Deputy Labor Commissioner of DLSE conducted an inspection of an equipment design firm. The inspection was generated by a labor union and an email of the complaint was received by the EETF Agent. The employer was registered with EDD at the time of the inspection. At the business, the team observed 10 employees. The DLSE agent issued a \$5,000 citation for lack of workers' compensation insurance. A subsequent EDD audit revealed that the employer had been out of compliance for seven years. The EDD tax auditor determined that the employer failed to report subject wages of \$3,777,002 paid to eight unreported employees. The employer was assessed \$1,200,721 for unpaid payroll taxes, penalties, and interest, including fraud penalties.

JESF Joint Criminal Prosecution Cases

The JESF member agencies refer cases to their respective criminal investigation organizations. The following are two examples of cases that JESF member agencies worked together to prosecute in 2009.

- The EDD Investigation Division, DOI, and Monterey County District Attorney's (DA) Office conducted a joint criminal investigation of a fast food chain restaurant in Monterey County. It was alleged that the employer withheld payroll taxes from the employees' wages, and intentionally did not report the wages and the employees to EDD. The employer also did not report the wages and the employees to the insurance company for workers' compensation purposes. The Monterey County DA prosecuted the employer. On September 30, 2009, the employer was convicted of UIC §2108 and Labor Code §3700.5, was sentenced to serve 90 days in county jail or complete an equivalent work alternative program, and was placed on felony probation for three years. The employer was also ordered to pay EDD \$23,785 in restitution, California Workers' Compensation Fraud Account \$41,311 in fine, and the Monterey DA's office \$10,000 in statutory fine. The EDD restitution payment of \$23,785 was received in full on October 8, 2009.
- The EDD Investigation Division and the Santa Clara County DA's Office conducted a joint criminal investigation of a roofing contractor in Santa Clara County. It was alleged that the employer intentionally underreported wages to EDD and paid employees in cash to avoid paying the proper payroll taxes to EDD. The employer also misreported wages to State Compensation Insurance Fund (SCIF). The Santa Clara County DA prosecuted the employer. On April 28, 2009, the employer was convicted of UIC §2117.5, §2118.5, §2101.5, Insurance Code §11880(a), and Penal Code §186.11(a)(1), and was sentenced to serve 10 months in county jail and was placed on five years formal probation. The employer was also ordered to pay the EDD and SCIF \$174,169 and \$227,339 in restitution, respectively.



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