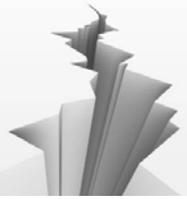


THE TAX GAP, THE UNDERGROUND ECONOMY, AND THE CRIMINAL ELEMENT

Economic and Statistical Research Bureau and
Criminal Investigation Bureau

The Tax Gap

The
Tax
Gap



- Defined by the IRS as the difference between the amount of tax owed by taxpayers and what is paid on time
- It is estimated that CA's tax gap is approaching \$12 billion in FY 10/11 (\$10 billion net after enforcement/collections)
- Primarily consists of nonfiling, underreporting and underpayments
- While there is overlap with the underground economy, it is important to note that the terms are not synonymous

The Underground Economy

- The underground economy can be defined as economic activity of individuals and businesses that deal in cash and/or use other schemes to conceal their activities and true tax liability from government licensing, regulatory and taxing agencies
- Establishing an estimate of the underground economy is difficult relative to the already complex quantification of the tax gap
- Most efforts to quantify the underground economy approach the problem from a macroeconomic perspective
 - Commonly applied methods such as the transactions approach, currency demand approach, and physical input method predict a range of approximately 7% to 14% of GDP attributable to the underground economy.

Underground Economy Cont'd

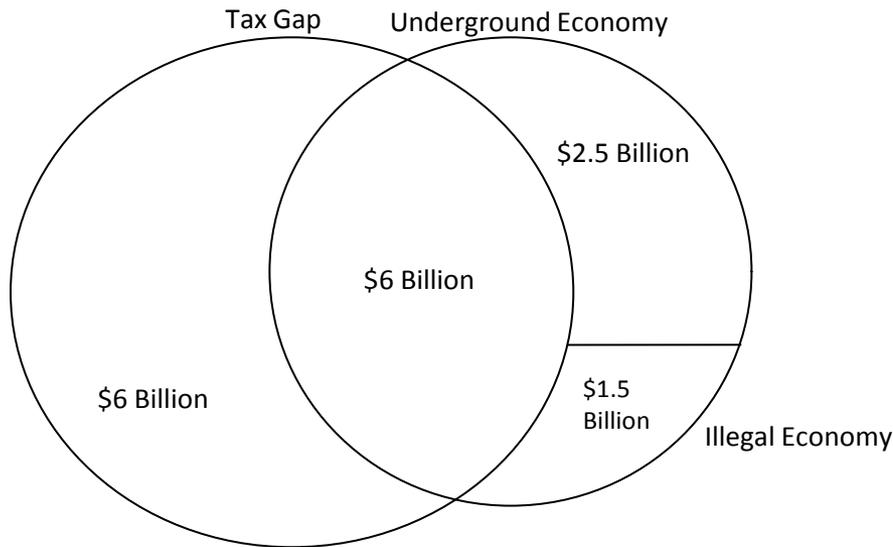
- IMF and World Bank estimates place the underground economy of the U.S. at approximately 8.4% of GDP.
- If we apply this conclusion to the CA economy, the CA underground economy could be approximately \$170 billion
- Assuming the average income tax rate to be 6%--the approximate loss to CA may be upwards of \$10 billion in income tax revenues

The Illegal Economy



- A subset of the underground economy, the illegal economy is simply defined as untaxed illegal economic activity
- It is comprised of both illegal activities for which there are no legal substitutes (ex. human trafficking) and illegal activities which subvert a legal industry (ex. movie piracy)
- In these cases criminal penalties resulting in tax revenue may be appropriate but the primary policy goal is the elimination of illegal activity
- The illegal economy is particularly difficult to estimate due to the incentive for participants to conceal their activities, and the ensuing lack of data
- By pulling together existing third party estimates of several illegal activities we find the illegal economy makes up approximately 15% of the underground economy

Intersection of the Tax Gap (\$12 B) and Underground Economy (\$10 B)

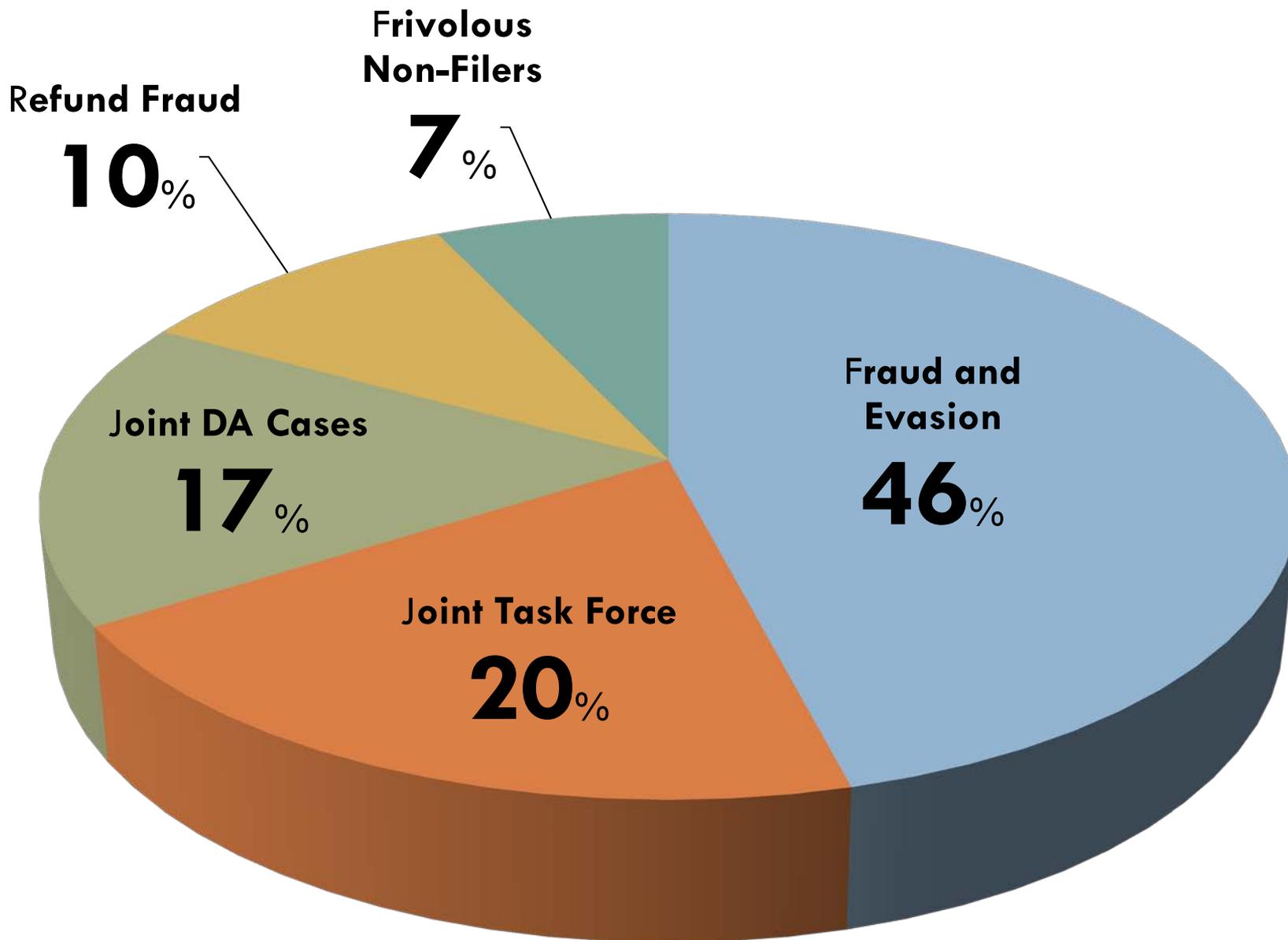


- We attribute the entire non-filing portion of the tax gap to the underground economy
- In addition, a substantial portion of underreporting of income (but not overstated deductions) is attributed to the underground economy
- While estimating an exact overlap is difficult, it is not impossible and using IRS tax gap estimates of self employment underpayments and individual income under-reporting of business income we arrive at an estimated 50% of the tax gap may be attributed to the underground economy

Criminal Investigation Bureau: Who We Are

- 62 Total staff
 - 41 Sworn Officers
- Background and Experience
 - Bachelor degree and above; Accounting
 - Certified Public Accountants
 - Certified Forensic Computer Examiners
- Peace Officers
 - Carry concealed firearms
 - Execute Search Warrants
 - Effect Arrests

Criminal Investigation Bureau Workload



Results – Calendar Year 2011

- Cases Initiated - 100
- Cases Closed – 281
- Convictions – 58
- Arrests - 51
- Search Warrants – 33 (120 Locations)

Publicity

- Orinda Physician Arrested on State Income Tax Charges
- Laguna Beach Man Gets Jail for Fraud, Grand Theft, and State Income Tax Evasion
- Orange County Auto Fleet Salesman Pleads Guilty to State Income Tax Evasion

Challenges and Opportunities



- Human Resources/Recruitment
- Collaboration and Data Sharing
- Enhanced & Designated Funding for Prosecuting Offices
- Enhanced publicity

Together

We can effectively address
the underground economy &
combat illegal activity

Questions...Comments...