

January 30, 2008

The California Bottom Line

\$8.5 billion in uncollected taxes

“*The Legislative Analyst’s Office, FTB and BOE estimate that the state fails to collect an estimated \$8.5 billion that it is owed. The law-abiding taxpayers of California deserve something stronger and more ambitious—they deserve a tax collection system that is fair.*”

—Jim Hard, President
SEIU Local 1000

Uncollected taxes exceed \$8.5 billion per year according to the state's own estimates

This first edition of *The California Bottom Line* summarizes the \$6.5 billion in personal income and corporate taxes, and \$2 billion in sales and use taxes that the Legislative Analyst's Office (LAO), the Franchise Tax Board (FTB), and the Board of Equalization (BOE) estimate go uncollected each year.

The governor said he wants to correct structural flaws that force the state into deficit spending when revenues fall. But we believe that if California were able to do a better job going after unpaid taxes, we could have a more accurate basis for evaluating the state's long-term financial needs. These are taxes that are already owed to the state but are not being paid.

So far the results of several modest pilot programs suggest that a big push to crack down on uncollected taxes could raise billions. We believe that when it comes to tax enforcement, it's time to stop studying and start collecting. However, the governor's 2008-09 budget proposal would only reduce the tax gap by a small percent.¹

LAO urges increase in tax enforcement

The Legislative Analyst has endorsed a variety of solutions for more effective collection of taxes owed California,² including:

- Target independent contractors
- Go after corporate non-filers
- Boost resources to identify corporate and individual non-filers

Last year, the LAO also urged stronger enforcement actions: "We recommend that the Legislature redirect some proposed budget year spending on tax gap enforcement activities in order to increase their payoff in terms of General Fund revenues."³ The LAO's solutions require reallocating tax gap efforts to focus more on enforcement and on strengthening penalties, and less on education; according to the LAO, "the state could get a bigger revenue bang for its enforcement buck."⁴

Tax amnesty program grossed \$4.8 Billion

In addition to the LAO's recommendations, we believe the state should consider an amnesty program that will bring in payments owed by taxpayers who want to avoid the brunt of new enforcement efforts. In 2004-05, The Voluntary Compliance Initiative brought in \$1.4 billion from taxpayers seeking to avoid penalties by voluntarily paying taxes they had previously avoided through the use of abusive tax shelters. The Tax Amnesty Program brought in \$4.8 billion from other taxpayers who used the opportunity to come into compliance with the provisions of tax law and thereby avoid penalties.⁵ Notwithstanding that the revenue this program generated was from non-compliance over a few years, the size of the tax gap warrants reviewing this program again.

BOE: 30% of problem is due to tax evasion

The BOE estimates that unpaid sales and use taxes are broken down as follows:

- 12% are businesses and individuals who underreport sales
- 30% are non-filers and tax evaders
- 58% are transactions with out-of-state retailers⁶

FTB: Underreporting income is a serious problem

The FTB estimates that the tax gap is made up of three main segments:

- 80% is individual and corporate taxpayers that either over-deduct expenses or underreport income
- 10% is individuals that do not file tax returns
- 10% is taxpayers that have paid less than the reported taxes they owed ⁷

The FTB states that the top five industries for non-filers are: health services, business services, personal services, real estate and engineering/accounting.⁸

At the national level, the IRS estimates that sole proprietors (who are often independent contractors) that underreport their income make up 20% of the federal tax gap.⁹ It is likely that this statistic is similar in California.

Percentage of Businesses, By Sector, That Underreport Income¹⁰

The FTB states that, “sole proprietors make up the highest percentage rates of personal income tax underreporting.”

- 60% to 70% of Antique Dealers
- 55% to 65% of Restaurants
- 45% to 55% of Used Car Dealers
- 40% to 50% of Auto Repair Businesses
- 35% to 45% of Landscaping Businesses

(Data from FTB—see footnote 10)

Corporate Tax Underreporting By Industry¹¹

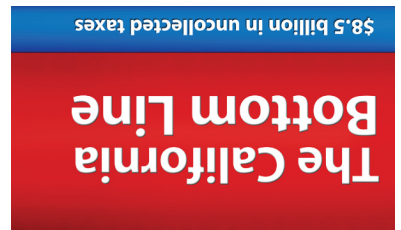
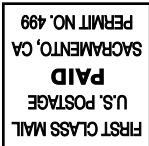
The FTB reports statistics on corporate underreporting; they estimate that the percentages of underreported income for the following industries are as follows:

- 32% for Services (doctors, lawyers, hotels, etc.)
- 25% for Retail Trades
- 23% for Finance
- 20% for Transportation, including communications and utilities
- 20% for Construction

(Data from FTB—see footnote 11)

Documentation

1. Total over two years at both agencies is \$119 million: FTB: \$6.4 million from the General Fund and 68 positions in order to generate \$22 million in 2008-09 and \$39 million in 2009-10; BOE: \$13.9 million (\$9 million from the General Fund) and 129 positions in order to generate \$20 million in 2008-09 and \$38 million in 2009-10
2. Legislative Analyst's Office. “Analysis of the 2007-08 Budget Bill: General Government: Franchise Tax Board.” (starting page F-52) http://lao.ca.gov/analysis_2007/general_govt/gengov_anl07.pdf
3. Ibid, p. F-56.
4. Ibid, p. F-56.
5. Franchise Tax Board, “2006 Tax Gap Plan”, p. 5.
6. Board of Equalization. “Addressing the Tax Gap: Fiscal Years 2007-2008 through 2009-2010.” April 2007. <http://www.boe.ca.gov/news/pdf/gapdoc.pdf>
7. Reported in: Franchise Tax Board. “Tax Gap FAQs.” <http://www.ftb.ca.gov/amnesty/taxgap/faqs.pdf> ; based on: GAO Report: IRS Can Better Pursue Noncompliant Sole Proprietors, Aug. 1994. <http://archive.gao.gov/t2pbat2/152467.pdf>
8. Ibid
9. GAO. “Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance.” Aug. 14, 2007. <http://www.gao.gov/htext/d071014.html>
10. Reported in: Franchise Tax Board. “Tax Gap FAQs.” <http://www.ftb.ca.gov/amnesty/taxgap/faqs.pdf> ; based on: GAO Report: IRS Can Better Pursue Noncompliant Sole Proprietors, Aug. 1994. <http://archive.gao.gov/t2pbat2/152467.pdf>
11. Ibid



There's an alternative way to address California's budget crisis beyond raising taxes or cutting services:

- The Legislative Analyst estimates uncollected income taxes exceed \$6.5 billion annually.
- The Franchise Tax Board says underreporting income is a serious problem.
- The Board of Equalization estimates uncollected sales and use taxes are \$2.0 billion annually.

Look inside for details on California's uncollected tax bills.



SEIU Local 1000 is California's largest union of state employees, representing more than 92,000 workers including tax auditors, tax compliance representatives and other professionals throughout state service.