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FRAUD LEGAL REPORT

LOS ANGELES COUNTY DISTRICT ATTORNEY'S OFFICE

Committed to Stopping Insurance Fraud

Battling the Underground Economy

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The Underground Economy has a drastic impact upon law-abiding businesses, consumers, and workers. It spans all areas of the economy but is particularly prevalent in the construction industry. Underground Economy businesses cheat law-abiding businesses by underbidding them, and the Underground Economy drains tax revenue from the government. This issue of the *Fraud Legal Report* addresses the Underground Economy as well as laws which can be used to level the playing field for honest businesses.

UNDERGROUND ECONOMY BUSINESSES DEFINED

“Underground Economy Businesses” include those businesses which obtain an *illegal* competitive advantage. They accomplish this in a variety of ways, including:

- Not obtaining required licenses;
- Failing to report worker injuries to keep the business' workers' compensation insurance experience modification [“X-Mod”] low and insurance premium artificially low;
- Lying on workers' compensation insurance applications to obtain a lower rate;
- Not providing workers' compensation insurance for employees; and/or
- Failing to pay payroll and other taxes.

These are significant burdens. By illegally avoiding them Underground Economy businesses have lower costs which allow them to underbid law-abiding businesses and prevent owners of those businesses which play by the rules from making an honest living. Underground Economy businesses also often put workers at risk by violating overtime laws, not providing workers' compensation insurance, and violating minimum wage laws.

CONTRACTOR ISSUES

Business and Professions Code Section 7028 requires every California contractor to have a current license through the Contractors State License Board. Additionally, under Business and Professions Code Section 7125 contractors must have workers' compensation coverage for each employee. If the contractor has no employees, he/she does not need to have workers' compensation coverage, but he/she must file a statement of exemption as required by Business and Professions Code 7125(b). If a business has an employee(s), failure to maintain workers'

compensation coverage will lead to the automatic suspension of the contractor's license under Business and Professions Code Section 7125.2.

INSURANCE FRAUD

Underground Economy businesses commit several different types of insurance fraud to obtain a cost advantage over law-abiding competitors.

X-Mod Fraud occurs where a business illegally fails to report a worker's injury to the business' insurance company. This is a violation of Penal Code Section 550. A conviction of that section can be punished by probation and/or incarceration in County Jail or state prison.

Premium Fraud occurs when a business lies in order to obtain a lower insurance rate. The lies can include misrepresentations of the number of workers it employs, the classification(s) of its worker(s), and/or the amount of its payroll. Premium Fraud is prosecuted under Insurance Code Sections 11760 and 11880 depending upon whether the victim insurer is State Fund or another insurance company. A conviction of either section can be punished by probation and/or incarceration in County Jail or state prison.

FAILING TO PROVIDE WORKERS' COMPENSATION INSURANCE

Every business must provide workers' compensation coverage and protections for its employee(s). Labor Code Section 3700 requires this for full time, part time, occasional, and seasonal workers. To provide the legally required workers' compensation protection, the business must be legally self-insured [which is complicated] or it must obtain workers' compensation insurance. Failure to provide either is a violation of Labor Code Section 3700.5 which requires a fine of \$10,000 for the first offense or incarceration in County Jail. A subsequent offense requires a \$50,000 fine or incarceration in County Jail.

TAX FRAUD

Often, when a business commits fraud, it is not limited to any one area. Underground Economy Businesses frequently commit Payroll Tax Fraud. They pay workers in cash, fail to provide itemized statements with a worker's check, and/or fail to pay state payroll taxes such as disability insurance, unemployment insurance, and/or social security taxes.

These violations can be prosecuted under the following sections:

- Labor Code 226: An employer must provide itemized pay statements even if the employee is paid in cash.
- Unemployment Insurance Code 2108: It is unlawful to fail to make unemployment insurance contributions.
- Unemployment Insurance Code 2117.5: Unemployment insurance tax evasion.

If an Underground Economy Business commits State Income Tax Fraud, charges can be filed under Revenue and Taxation Code 19705 [Filing a False State Income Tax Return] and/or Revenue and Taxation Code 19706 [Failing to File a State Income Tax Return].