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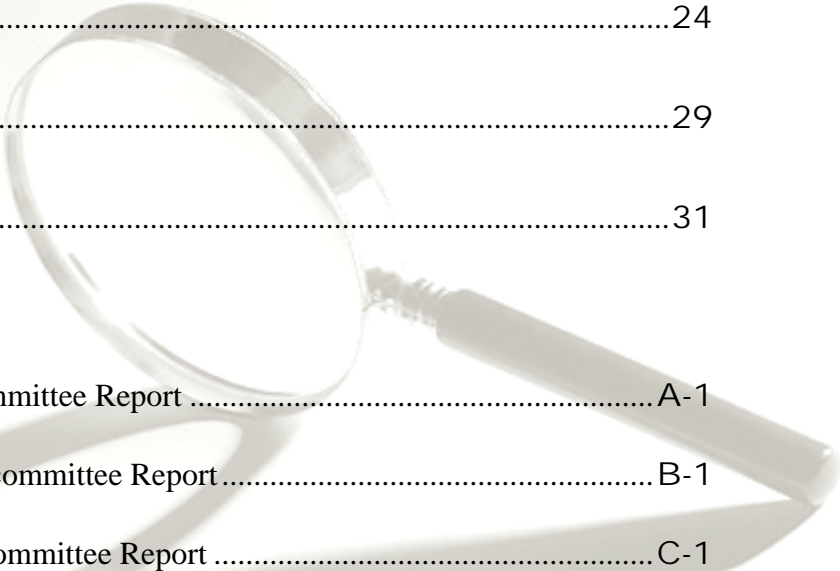
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# INTRODUCTION

By Justice Maura D. Corrigan

I am honored to introduce this report from the Michigan Underground Economy Task Force. It reflects the dedicated work of highly qualified professionals who volunteered their time to investigate the underground economy and search for ways to collect child support and taxes from those who earn unreported income in that shadow economy.

For many years, I have served as the judiciary's liaison to the child support community. That led to my appointment to the National Judicial Child Support Task Force, a study group that assists the federal Office of Child Support Enforcement. There, I learned about the underground economy's *huge* adverse impact on child support collections, thanks to presentations by a fellow NJCSTF member and two key OCSE personnel. For that, I am indebted to Marilyn Ray Smith, Chief Legal Counsel for the Massachusetts IV-D program, former OCSE Commissioner Margot Bean, and Dennis Putze, one of OCSE's statistics wizards.

Quantifying America's underground economy and the harm that income-concealment does to children led us to launch this Michigan-based task force and seek solutions to the many problems created by the underground economy. The Michigan Office of Child Support, our state's IV-D agency, provided grant funding for our work. Michigan consistently ranks among the national leaders in child support enforcement as measured by the federal government's performance criteria. OCS Director Marilyn Stephen both arranged our grant funding and made invaluable contributions as a member of this task force.

Our report includes an excerpt from a May 1, 2010, *New York Times* article about Greece's underground economy. That article reports that Greece's shadow economy accounts for over 25% of the country's gross domestic product. As we prepared to print this report in June 2010, it remained possible that, because of its failure to collect taxes on that underground income, Greece will default on its government debt and be forced out of the European monetary union. Those events would have a catastrophic economic impact on most Greek citizens.

By contrast, the American underground economy accounts for about eight percent of the United States' GDP. But the International Monetary Fund estimated that our GDP totaled \$14.3 trillion in 2009, versus 3.3 billion for Greece, so percentages do not tell the full story. Our country too, has huge problems attributable to the underground economy. Those problems include a huge shortfall in our collections of both child support payments and taxes. According to current OCSE Commissioner Vicki Turetsky, one in four American children are involved in a child support court case. Meanwhile, however, 42 percent of child support obligors do not report any wage income.

Those problems will only become worse if we do not attack the underground economy. We harbor no illusions that all our recommendations will be adopted, or that the underground economy would disappear if all the recommendations were adopted. We hope, however, that our report will advance the ongoing search for solutions.

# MEMBERS OF THE UNDERGROUND ECONOMY TASK FORCE

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The task force thanks all of the SCAO employees who provided staff support, and especially those listed below.

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## FUNDING SUPPORT

MICHIGAN DEPARTMENT OF HUMAN SERVICES, OFFICE OF CHILD  
SUPPORT

# EXECUTIVE SUMMARY

## OVERVIEW

Legislators, executive branch officials, law enforcement personnel, and jurists need complete and accurate information in order to enact wise laws and enforce them fairly. In our democracy, government officials represent and serve all citizens. Whether one agrees or disagrees with a particular government action, we all benefit when government officials base their decisions on accurate information.

Unfortunately, the officials who administer our laws governing child support and taxation often lack accurate information about the people and transactions that their decisions affect. This report explores one important cause of that information deficit: the phenomenon known as the “underground economy.” More specifically, we will examine how the underground economy deprives minor children of financial support from their parents. In addition, because the underground economy enables tax evasion for the same reasons that it hinders child support enforcement, this report will offer some recommendations that also apply to tax matters.

A person’s tax and child support obligations should be determined by that person’s income and assets. But people who operate in the underground economy intentionally conceal their finances. As a result, the government personnel who determine tax and child support obligations lack some of the information they need. This allows the underground economy participants to enrich themselves illegally by underpaying both taxes and child support. These tactics are illegal and immoral when they merely deprive governments of tax revenue. They deserve the strongest possible condemnation when parents use them to avoid supporting their children.

This task force recommends three broad strategies for attacking the underground economy. They are: Prevention, Collaboration, and Enforcement.

**Prevention:** Many child support obligors flee into the underground economy to avoid an overwhelming support debt. We must assure that the initial support order accurately reflects the obligor’s financial circumstances, and we must intervene promptly if those circumstances change or the obligor misses a payment.

**Collaboration:** People rightly fear the classic Orwellian specter of an all-knowing Big Brother government, but government agencies usually operate within vertical “silos” that inhibit information sharing. While respecting privacy rights, we can improve communications among government agencies, and between those agencies and the private sector.



**Enforcement:** No combination of enforcement methods will ever completely eradicate the underground economy. Our objective is to impede and punish underground economic activity with an array of enforcement techniques that make doing business underground so difficult and costly that *most* people who engage in *financially significant* underground transactions will conclude that operating legally serves their own interests.

We distinguish the “the underground economy” as a societal pathology from the real people who work in the underground economy. The three strategies summarized above and the detailed recommendations presented later in this report are designed to work on both levels. The underground economy is an evil that we should suppress, but most people who work underground struggle just to earn enough to support themselves. Moreover, some noncustodial parents who work underground feel that they were forced there by an unreasonably high child support order or an insurmountable support debt. We should offer these parents an accessible path to debt relief and encourage them to become true parents to their children.

No member of this task force believes that the underground economy will disappear with the adoption of our recommendations. We hope, however, that this report will advance the search for solutions and thereby help many children who otherwise would grow up without financial support from their parents.

## THIS UNDERGROUND ECONOMY TASK FORCE

Michigan Supreme Court Justice Maura D. Corrigan formed this Underground Economy Task Force in June 2008. She asked the group to first search for innovative ways to increase Michigan’s collections of child support and taxes from people who work in the underground economy, and then to publish a report that she could present to interested officials in Michigan and nationally. The Michigan Office of Child Support, Michigan’s designated Title IV-D agency, has provided generous grant funding for this study and report.

Because the underground economy causes considerable problems for both tax collection and child support enforcement, Justice Corrigan recruited several task force members who have tax law expertise, as well as many experienced child support professionals. The tax experts’ previous work on detecting unreported income has informed the task force’s deliberations. All the members hope that this report’s recommendations will assist both enforcement efforts.

## THE TASK FORCE’S DELIBERATIVE PROCESS

During organizational meetings in the summer and fall of 2008, the task force formed three specialized subcommittees: Prevention, Collaboration, and Enforcement. Each member

of the task force served on one of those subcommittees, which met frequently during the intervals between task force meetings.

The entire task force met at quarterly intervals from 2008 through 2010 to receive updates from the three subcommittees. In addition, all members had an opportunity to make presentations about their professional backgrounds and their experiences with various aspects of the underground economy. These presentations allowed the entire task force to benefit from the members' collective expertise.

At scheduled intervals, each of the three subcommittees filed a printed report and presented that report at a task force meeting. See Appendix A (Prevention), Appendix B (Collaboration), and Appendix C (Enforcement). The task force then discussed each subcommittee's recommendations.

This overview report by the entire task force synthesizes the subcommittee recommendations and the resulting task force discussions. All the subcommittee recommendations are presented briefly in this report, but the more-detailed subcommittee reports found in the appendices merit separate consideration, especially by those who want more information about a particular recommendation.



As the Underground Economy Task Force worked to complete this report during May 2010, the news media were filled with stories about Greece's dire economic straits and expert observers' speculation about whether the other eurozone countries could and would rescue Greece. The following article provided a dramatic example of how tax evasion taken to the extreme can cripple an entire country.

*"In the wealthy northern suburbs of [Athens], where summer temperatures often hit the high 90s, just 324 residents checked the box on their tax returns admitting that they owned pools. So tax investigators studied satellite photos of the area—a sprawling collection of expensive villas tucked behind tall gates—and came back with a decidedly different number: 16,974 pools. That kind of wholesale lying about assets, and other eye-popping cases that are surfacing in the [Greek] media [illustrate] the staggering breadth of tax dodging that has long been a way of life here."*<sup>1</sup>

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<sup>1</sup> *New York Times*, May 1, 2010, A1.



## RECOMMENDATIONS

The **Prevention Subcommittee** focused on identifying the reasons why people enter the underground economy. There are two types of underground economy participants: “strategists” and “reactivists.” Those in the first group are willful criminals—people who strategize ways to avoid meeting their financial obligations, including taxes and child support. Reactivists, on the other hand, are more likely to have gone underground primarily to escape (for a time) obligations that they perceive as either unreasonable or impossible. The subcommittee’s recommendations presented on page 17, and detailed in Appendix A, suggest ways to avoid forcing this group to go underground, and to entice those already there to emerge



Many ex-prisoners become what the task force’s Prevention Subcommittee called “reactivist” participants in the underground economy. That happens because parents who go to prison often accrue substantial child support arrearages while incarcerated and indigent; and because current federal law prohibits retroactively reducing a support debt to reflect the obligor’s actual past circumstances. When those parents later leave prison, an impossibly large support arrearage can cause them to flee into the underground economy. Michigan’s Washtenaw County has a “Prisoner Release Project” that assists both new prisoners (by petitioning for an immediate support abatement) and parolees (by arranging easier payment terms and the forgiveness of some debts). A jurist from that county explained:

*“The reality is that these individuals are returning to a society where they will line up behind skilled workers without criminal histories, and without the [other] impediments that interfere with the released prisoner’s efforts to find a job. Last week, I encountered one such payer who lost her driver’s license several years ago and has had the \$500 [Michigan] Driver Responsibility Fee added every year, even during her incarceration. She cannot get her license reinstated until she pays over \$6,000 in fines and, consequently, cannot find a job because she has no transportation.... Although not every case presents the challenges outlined above, most offer the opportunity to re-establish relationships between the [support] payer and the children.... The sooner I see the payers the better for all concerned, for obvious reasons.”<sup>2</sup>*

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<sup>2</sup> Letter to the Underground Economy Task Force from Washtenaw County Domestic Relations Referee Lisa Wenger.

and resume normal lives. In the child support context, the recommendations emphasize three main concepts:

- Limit the accrual of large arrears by establishing accurate support levels in the first instance. The federal government could provide a major assist here by rewarding states for obtaining *non*-default support orders and for *actual collections* in default cases.
- Respond immediately to missed payments or changed circumstances.
- Make it possible for obligors with large arrears to live in the open if they resume paying current support and make reasonable efforts to reduce their arrears.

The **Collaboration Subcommittee** recognized that government organizational structures create “silos” that isolate agencies and the information they possess. The Collaboration Subcommittee recommendations on page 22, and detailed in Appendix B, suggest ways to improve the sharing of information vertically (federal, state, and local governments), horizontally (between agencies at each level of government), and holistically (between government agencies and citizens). We anticipate that many people will voice concerns that improved interagency collaboration will create an all-knowing “Big Brother.” Those concerns are reasonable, but we also know that taxpayers demand government effectiveness and efficiency. Our collaboration recommendations try to balance those considerations.

The **Enforcement Subcommittee** observed in its report that the underground economy hits us with a scattershot array of problems, a fact that often requires us to respond with an ad hoc countermeasure for each problem. Ironically, new or improved laws cannot totally eliminate the underground economy because it is laws themselves (especially tax laws) that create the strongest financial incentives to join the underground economy. Our enforcement goal should be to impede and punish underground economic activity with multiple enforcement techniques that make doing business underground so difficult and costly that *most* people who engage in *financially significant* underground transactions will conclude that operating legally furthers their own interests.

The Enforcement Subcommittee’s recommendations are presented on page 24, and are detailed in Appendix C. Here are two highlights:

- Impose meaningful sanctions on employers who actively participate in the underground economy or knowingly enable their employees to do so.
- Arrange for IRS agents to train state child support enforcement personnel on methods for detecting underground economy activity. This specific recommendation also would advance the Collaboration Subcommittee’s efforts to improve communication between levels and branches of government.



“How many haircuts is that tune-up worth?” That rhetorical question appears in a website promotional blurb for the Midwest Business Exchange [[www.mbebarter.com](http://www.mbebarter.com)], a “barter and trade” association whose members exchange goods and services for either comparably valued goods and services or the association’s own currency, called “trade dollars” by the MBE and “barter dollars” by other such groups. The MBE’s blurb continues:

“With money tight, bartering is growing in popularity. It’s been estimated that there are over 400 exchanges in North America, totaling 350,000 to 400,000 businesses, doing an estimated 3.5 to 4 billion dollars in trade annually.”

The websites for many of these organizations include a statement that the organization annually files an IRS Form 1099-B reporting each member’s “sales” for the past year. The task force has not attempted to verify those assertions, but assuming that a barter exchange does file tax reports, how accurate are those reports? Consider the following “Why barter?” explanation by The Barter Club, Inc. [[www.thebarterclub.com](http://www.thebarterclub.com)]:

*“Example: The pizza [shop] owner sells \$100 worth of pizza and drinks[,] which maybe costs [sic] \$30. He then buys \$100 worth of tires. He truly spent %30 [sic], his cost of the food and drinks. Everyone profits when they buy wholesale” ... [And, later] “The Barter Club does not fill out 1099b [sic] forms for corporations as [sic] they are exempt.”*

*Questions:* If a hypothetical *unincorporated* pizza shop owner obtains tires with a fair market value of \$100, but the barter exchange reports only \$30 on IRS Form 1099-B, how much gross income did the owner receive? Similarly, what income figure should child support personnel use to calculate his support obligation? And what happens if a supposedly “exempt” corporation owns the pizza shop?

A final note about bartering: Our research did not discover any barter organization that acknowledged reporting members’ transactions to state governments.

# TASK FORCE REPORT

## DEFINING THE “UNDERGROUND ECONOMY”

A 2007 Internal Revenue Service report defined the “underground economy” as “the value of goods and services that elude official measurement.”<sup>4</sup> They “elude” us because underground economy participants ignore their duty to report transactions in which they exchange those goods and services. Not reporting the transactions enables those people to evade their taxes and other financial obligations, or to conceal crimes.

A substantial number of people join the underground economy to avoid paying taxes, but many have additional motives, including a desire to conceal their income from creditors. This report focuses on one category of debtors: noncustodial parents who choose to work in the underground economy in order to avoid providing financial support for their children. In

addition, because almost every underground economy participant evades some tax obligations, this report also will examine selected tax-evasion aspects of the underground economy problem.



Merchants who receive cash payments always could reduce their reported incomes by failing to record some transactions. That becomes riskier if the merchant has employees or uses computerized cash registers; but where there’s a will, there’s a way. From 2001 until 2005, the owner of the La Shish restaurants in metropolitan Detroit used a commercially available computer program (functionally similar to “zapper” software) to systematically understate his recorded cash receipts by more than \$20 million. When IRS agents searched the La Shish office in 2005, they found and seized more than \$1 million in cash. The owner had previously moved most of the remaining \$19 million out of this country. A substantial portion of that money ultimately went to the Hezbollah terrorist organization to support the orphans of Hezbollah “martyrs” (*i.e.*, suicide bombers).<sup>3</sup>

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<sup>3</sup> Source: Case documents from *United States v Elfat El Aouar*, US District Court, ED Michigan, Southern Division, Docket No. 06-20248.

<sup>4</sup> *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance* (2007), at p 6. [http://www.irs.gov/pub/irs-news/tax\\_gap\\_report\\_final\\_080207\\_linked.pdf](http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf) (Accessed 5/17/10).

Most people encounter some facet of the underground economy every day, but they seldom pause to consider exactly what we have seen or how it affects them. Here are three common examples:

- Unreported exchanges of goods or labor for cash or a cash-equivalent. The transactions themselves may be legal, but not reporting them enables one or both participants to evade a variety of taxes and other financial obligations.
- Employer misclassification of employees as independent contractors or casual laborers, a tactic that allows the employers to completely avoid paying employment-related taxes and insurance premiums. “Misclassification” also covers the *underreporting* of employee wages to *reduce* the employer’s liability for those same taxes and premiums.
- Crimes, especially quasi-business crimes, such as drug dealing and embezzlement.

## THE UNDERGROUND ECONOMY HARMS CHILDREN

This report will discuss ideas for preventing and detecting underground economy transactions. Successful implementation of our recommendations will increase state and federal tax revenues at a time when governments at all levels face large budget deficits. But the underground economy also serves to conceal money that should provide financial support for the children of underground economy participants. The need for better enforcement of the laws requiring parents to support their own children was the primary impetus for forming this task force and publishing its report. Therefore, we believe it appropriate to begin with some brief observations about how the underground economy harms children and, by extension, all of us.

The connection between collecting more child support and helping children will seem obvious to most people, but others may question whether children can realize a *net* financial benefit if the reforms recommended by this report result in higher tax payments, thus reducing parents’ spendable income and perhaps even driving those parents deeper into the underground economy. For the reasons detailed below, we are convinced that children will, indeed, benefit significantly.

Throughout human history, all civilizations have expected parents to support their children until the children reach adulthood. At the heart of the specific problem presented to this task force lies the sad truth that far too many parents now refuse to accept that inherent responsibility to support their children.

A child’s need for support results from two human characteristics, one biological and the other social. First, our children take many years to reach physical and intellectual maturity. Second, although there was a time in Western culture when twelve-year-olds could assume

adult responsibilities, that time ended long ago. As human societies have become increasingly complex and crowded, the threshold for adulthood has risen to at least age 18. Until then, children need their parents' financial support, and the rest of us benefit if they receive it.

Long ago, if parents died or became unable to provide support, their extended family or tribe might provide for the children. Later, organized charities emerged to help some children. As "states" emerged as the most common form of government, they began to devote some tax revenue to the support of needy children. But all of those support structures were designed to help children whose parents *could not* support them. Although there always have been some parents who *would not* provide support, they were few in number. That has changed in this country over the past several decades.

A dramatic increase in births to unmarried women has been the single most significant cause of that decline in parental responsibility. Children born to single women start life with a much-reduced chance that both parents will provide financial and emotional support.<sup>6</sup>

The high divorce rate in the United States also contributes to the child *nonsupport* pathology, albeit not to the same degree as parents who never marry at all. The majority of divorced noncustodial parents continue to support their children, but economic and emotional stresses cause a significant minority to avoid that obligation.

Individuals will make their own decisions whether to marry, conceive children, or divorce. This task force will leave it to



Children born to unmarried mothers accounted for 38.5 percent of all American children born during 2006. The final federal government data for more recent years is not yet available, but the Pew Research Center reported recently that the national number increased to more than 41 percent for 2008. The Michigan data point the same way. For 2006, Michigan's comparable figure was 38.3 percent. The Michigan Department of Community Health's preliminary data indicate that the percentage of children born to unmarried mothers during 2009 increased to 41.6 percent.<sup>5</sup>

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<sup>5</sup> Sources: U.S. Centers for Disease Control and Prevention, <http://www.cdc.gov/nchs/fastats/unmarry.htm> (accessed 5/17/10); the Pew Research Center, <http://pewresearch.org/pubs/1586/changing-demographic-characteristics-american-mothers?src=prc-latest&proj=peoplepress> (accessed 5/17/10); and Michigan Department of Community Health, Division for Vital Records and Health Statistics, 1998-2009 Year-End Birthing Hospital Statistics.

<sup>6</sup> James Q. Wilson, *The Marriage Problem: How Our Culture Has Weakened Families*, HarperCollins Publishers, Inc. (2002).



others to debate the wisdom, morality, or necessity of those choices. For present purposes, the key fact is that increasing numbers of parents *will not* support their children.

Many in that group opt to work in the underground economy at least in part because doing so enables them to shield their earnings from child support enforcement efforts. We have no way to accurately measure the resulting underpayment of child support, but our best estimates of the underground economy's total size leave no room for doubt that it causes huge shortfalls. Children absorb the deficit by doing without essentials that their parents should provide.



The Great Recession that first manifested itself nationally during 2007 had already been hammering Michigan for many years. The Michigan birth data first cited in the previous insert reveal other trends that speak to state government's reduced ability to help all the children who need help. Michigan's population has remained essentially constant in recent years, but the number of children born here declined by almost seven percent from 2007 (final data) to 2009 (preliminary data). Meanwhile, however, the number of children born to unmarried mothers actually increased slightly during the same period.

A separate study of 2007 "unplanned pregnancy" data by the National Campaign to Prevent Teen and Unplanned Pregnancy found that women with incomes below the poverty line (\$10,787 for one person) accounted for approximately 30 percent of all unplanned pregnancies during 2007. And those with incomes less than twice the poverty threshold accounted for fully 60 percent.

It is not difficult to connect those dots and see why state government tax revenues have declined while the number of children who need government help has increased.

Until recently, America's federal and state governments have chosen to assume the added burden of supporting children whose parents *will not* do so. But governments and taxpayers are increasingly unwilling or unable to do that. Thus, while the number of willfully neglected children has continued to increase, our governments' ability to help them has declined. Those inversely correlated trends have created intolerable stresses for both children and governments. We no longer can afford—either financially or socially—to excuse parents who *will not* support their children.

Effective child support enforcement is a *relatively* inexpensive form of government assistance to children because most of the money comes from the children's parents. But the underground economy presents difficult enforcement challenges. The courts and agencies that administer our child support laws have no reliable way to consider underground economy income when they calculate how much support a parent should pay. Similarly, if

it later becomes necessary to enforce a support order, those courts and agencies will not know about unreported income and assets against which they otherwise could levy to collect past-due support. Meanwhile, the children will receive less support than they should, and often less than required to meet their minimum needs. Government payments may cover minimal needs, but “minimal” is not adequate.

Adding emotional insult to financial injury, parents who use the underground economy to hide money from the government sometimes also must hide themselves from the government. This self-concealment often requires that they have no contact with their children. Thus, the underground economy not only deprives children of financial support, it also may destroy any hope of a child having a continuing relationship with the underground parent.

## THE UNDERGROUND ECONOMY HINDERS CHILD SUPPORT ENFORCEMENT

Most readers of this report will have some knowledge of the state and federal laws that: (1) require parents to support their children; (2) authorize the states’ judicial and executive branches to enforce that obligation; and (3) provide partial federal funding for that enforcement.<sup>7</sup> At the federal level, child support enforcement efforts are coordinated for all states by the Office of Child Support Enforcement (OCSE) within the US Department of Health & Human Services.<sup>8</sup>

*✍*  
*In May 2010, OCSE  
Commissioner Vicki Turetsky  
reported that more than a  
quarter of all children in the  
United States are involved in  
child support cases.*

Federal, state, territorial, and local governments spend \$5.9 billion per year just to enforce parents’ inherent obligation to support their children.<sup>9</sup> Even with those expensive enforcement efforts, we still fail to order as much child support as we should, and we fail to collect enough of the support that we do order. Persons responsible for enforcing child support

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<sup>7</sup> All members of the task force are Michigan residents and, therefore, are most familiar with Michigan law. The federal financial participation rules require all states to have substantially similar child support laws.

<sup>8</sup> In Michigan, the child support enforcement responsibility is shared by an executive branch agency, the Office of Child Support (OCS) within the Department of Human Services, and the family division of the circuit courts. Each Michigan county has a “Friend of the Court” (FOC) office whose personnel handle much of the administrative work in child support and child custody cases. The FOC staff is made up of judicial branch employees of the county circuit courts.

<sup>9</sup> [http://www.acf.hhs.gov/programs/cse/pubs/2009/reports/preliminary\\_report\\_fy2008/#figure10](http://www.acf.hhs.gov/programs/cse/pubs/2009/reports/preliminary_report_fy2008/#figure10).



*The latest quarterly wage report data indicate that 42 percent of child support obligors do not have any wage income. Some are self-employed and some are prisoners, but how do the rest support themselves if they actually earn nothing?*

laws can do so only if they have accurate information about parents' incomes and assets. By definition, the *underground* economy conceals income and assets.

The Internal Revenue Service recently estimated that the federal government has an annual "tax gap" of \$345 billion, representing the additional federal taxes that the IRS would collect if everyone reported all of their taxable income.<sup>10</sup> This country has a comparable "child support gap" between the amount of child support that our laws require parents to pay and the amount that parents actually pay. That child support gap has two major components.

First, courts and agencies order lower support payments than they would order if they had complete information about the parents' income and assets. Second, parents fail to pay a significant percentage of the support that courts and agencies do order.<sup>11</sup>

Only the ordered-but-unpaid component of the support gap can be tallied accurately. As of September 30, 2008, the federal Office of Child Support Enforcement reported that support arrears totaled \$105.5 billion nationally.<sup>13</sup> OCSE cannot estimate with reasonable accuracy how much additional child support parents would owe if they fully disclosed their finances.



The children of single moms are more likely than those of two-parent families to be abused, to drop-out of or be expelled from school, to become juvenile delinquents, to take drugs, and to commit adult crimes. Now, single-parent families are generally much poorer than two-parent families, and so some of those consequences may flow from poverty, not family structure. Two scholars, Sara McLanahan and Gary Sandefur, have painstakingly sorted out the independent effects of income and father absence. They conclude that poverty by itself accounts for about half of the differences in how children behave; the rest is explained by living in a one-parent family.<sup>12</sup>

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<sup>10</sup> *Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance (2007)*. [http://www.irs.gov/pub/irs-news/tax\\_gap\\_report\\_final\\_080207\\_linked.pdf](http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf) (Accessed 5/17/10).

<sup>11</sup> Nationwide, income withholding orders (IWN) and tax refund offsets (FTRO) accounted for 75% of all the child support payments collected and distributed during 2008. (\$23.5 billion collected via IWN or FTRO, out of \$32.2 billion total collected. [http://www.acf.hhs.gov/programs/cse/pubs/2009/reports/preliminary\\_report\\_fy2008/](http://www.acf.hhs.gov/programs/cse/pubs/2009/reports/preliminary_report_fy2008/)) But underground economy earnings escape both of these otherwise effective collection methods.

<sup>12</sup> Wilson, *supra* note 4, at 8.

<sup>13</sup> [http://www.acf.hhs.gov/programs/cse/pubs/2009/reports/preliminary\\_report\\_fy2008/table\\_5.html](http://www.acf.hhs.gov/programs/cse/pubs/2009/reports/preliminary_report_fy2008/table_5.html).

Even in the abstract, that \$105.5 billion number looks frightening. It becomes both more frightening and terribly sad if we narrow our focus, look past the dollar total, and contemplate the plight of a typical custodial household that must survive without financial support that the noncustodial parent should provide. What material things have the children gone without? What emotional and intellectual damage have they suffered because of one parent's decision to ignore the children's financial needs? How will those childhood deprivations affect the children's later lives and the lives of their own children?

Further, from the states' perspective, the underground economy problem sometimes interacts in counterproductive ways with the criteria for the federal funding of state child support enforcement. Detecting underground economy activity requires very intensive (and thus expensive) enforcement efforts. Meanwhile, the states with the largest underground economies will tend to receive comparatively less federal funding precisely because they do not currently collect enough support from underground economy obligors.

On a more positive note, although the current federal financial participation rules do not allow state IV-D agencies to spend federal money on *parenting time* programs, a new waiver program will allow states to apply for waivers of that restriction. As noted elsewhere in this report, underground economy workers' need to conceal themselves sometimes leads to total estrangement from their children. Federal funding for parenting time programs will help states address that aspect of the underground economy problem.

## THE UNDERGROUND ECONOMY ENABLES TAX EVASION

Tax evasion usually provides the *primary* motive for those who choose to work in the underground economy. Although this report emphasizes child support enforcement, the prevention and detection of underground economy activity are also keys to tax enforcement. Indeed, until quite recently, tax enforcement personnel were the only people actively studying and combating the underground economy.

As noted earlier, the Internal Revenue Service has estimated that the federal government has an annual "tax gap" of \$345 billion attributable to unreported taxable income. At the state level, the National Governors Association (NGA) asked its members to study how the "misclassification" of employees allows both employers and employees to evade state taxes and insurance requirements.<sup>14</sup> Responding to that NGA request, Governor Jennifer M.

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<sup>14</sup> Many state governments have also voiced concern about the revenue and anti-competitive consequences of their inability to collect sales and use taxes on residents' purchases from out-of-state merchants. That revenue problem worsens every year as Internet sales increase. A federally-approved interstate compact requiring interstate sellers

Granolm formed the Michigan Interagency Task Force on Employee Misclassification. That group's 2009 annual report to the Governor<sup>15</sup> estimated that more than eight percent of Michigan employees are "misclassified"—either because their employers falsely designate the employees as self-employed independent contractors, or because the employees' actual earnings exceed what the employers report.<sup>16</sup>



One member of this task force described how the underground economy affects her husband, who owns a Detroit automobile glass replacement business.

Many of his customers need replacement car windows because they have been victimized by smash-and-grab thefts. Almost daily, he turns away hustlers who offer to sell him bargain-priced audio equipment probably stolen from people like his customers. Although he refuses to further that cycle of crime, he must compete against less scrupulous operators who offer cheap and convenient "one-stop" shopping" for victims who need to replace broken windows *and* stolen radios.

Because this businessman's wife is the director of a local child support enforcement agency, he understands the importance of complying with child support income withholding orders (IWN). But he has had employees quit because he obeys that law. And many potential employees have told him that they will work only for cash, or only if he will ignore an IWN.

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to collect taxes for purchasers' home states would solve that tax shortfall problem, but it also would remove the competitive advantage now enjoyed by the interstate sellers. The NGA has studied the seller-collection idea, but has not been able to reach consensus because some states prefer the status quo. This particular issue is beyond the scope of our report.

<sup>15</sup> <http://www.michigan.gov/dleg/0,1607,7-154-11122-211291--,00.html> (accessed 5/17/10).

<sup>16</sup> The Michigan Interagency Task Force on Employee Misclassification derived its Michigan data from two sources: (1) employer audits for tax years 2003 and 2004 conducted by the Michigan Unemployment Insurance Agency; and (2) a subsequent "working paper" analysis of the construction industry data from those audits, *The Social and Economic Costs of Misclassification in the Michigan Construction Industry*, Dale L. Belman and Richard Block, Michigan State University, School of Labor and Industrial Relations (2008). The authors used the audited construction industry data to derive estimates for all Michigan employers and employees. They estimated that misclassification costs Michigan between \$36.3 and \$49.3 million per year in unpaid state taxes and unemployment insurance payments. Michigan now has a 24-hour toll free phone line that citizens can call to report suspected misclassification.

The Belman and Block paper adds that the IRS and the Social Security Administration certainly experienced much greater losses than Michigan because those federal taxes have higher percentage rates. If the federal tax gap is \$345 billion, then a very conservative estimate would indicate that Michigan accounts for *at least* \$7 billion of that gap. Further, neither the Michigan UIA audits nor the Belman and Block study attempted to account for the earnings of cash-only workers who never report any income.

In late 2008, this underground economy task force hosted a presentation by the misclassification task force in order to learn more about that group's research and focus. Because it appeared that they were examining only the misclassification aspect of the underground economy, the task force elected to continue this work separately. The two support staffs remained in communication about items of common interest.

Both types of misclassification allow the employers to underpay taxes, unemployment insurance contributions, and workers' compensation premiums. Employees who are misclassified by either method can turn that to their own advantage by underpaying their personal income taxes. And, for obvious reasons, employers who misclassify employees or underreport wages enjoy a substantial cost advantage over competitors who operate within the law.

Because tax evasion provides such a strong economic motive to disregard financial reporting requirements, all governments have an underground economy problem. The best that any government can do is minimize its tax gap by enacting reasonable tax laws and devising effective enforcement methods. This report offers several recommendations for improved enforcement of the current tax laws.

## THIS TASK FORCE

Michigan Supreme Court Justice Maura D. Corrigan has overseen the Michigan judiciary's work on child support enforcement for more than eight years, first as Chief Justice, and more recently as the Justice with primary responsibility for child support matters. While serving on the National Judicial Child Support Task Force (NJCSTF), Justice Corrigan learned about the underground economy's impact on child support collections during presentations by a fellow NJCSTF member<sup>17</sup> who characterized the underground economy as "the last uncharted territory in the world of child support enforcement." After hearing those presentations, the NJCSTF encouraged its members to study the problem in their home states. Concurrently, the federal OCSE under former Commissioner Margot Bean initiated national interest in studying this "uncharted territory." Justice Corrigan responded by organizing this Michigan-based task force and asking its members to search for ways to collect more child support and tax revenue from parents who work in the underground economy. The Michigan Office of Child Support (OCS), Michigan's designated Title IV-D<sup>18</sup> agency, has provided generous grant funding for this project.

Justice Corrigan personally recruited task force members with impressive credentials in a broad array of professional disciplines directly or indirectly related to child support

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<sup>17</sup> Marilyn Ray Smith, then the director of Massachusetts' Title IV-D program, and now that program's Chief Legal Counsel.

<sup>18</sup> "Title IV-D" is a shorthand citation for Title IV, Part D (Sections 451 through 469b) of the federal Social Security Act, codified at 42 USC 651 through 669b. Part D includes both federal mandates and federal funding authorizations for the states' child support enforcement programs. The Michigan Office of Child Support, in the executive branch's Department of Human Services, is Michigan's designated IV-D agency.



enforcement and taxation. The members with child support enforcement expertise include local and state child support program managers, two assistant state attorneys general, and a family court judge. Because the underground economy adversely affects the collection of taxes and child support in similar ways, Justice Corrigan also recruited several task force members who have extensive experience in tax law enforcement and government budgeting. They include an IRS special agent, a Justice Department attorney, a former Michigan budget director, a former Michigan state treasurer, an assistant state attorney general, and a veteran attorney who is counsel to several of Michigan's tribal casinos. Throughout the deliberations, all the members were encouraged to maintain a dual focus on both child support enforcement and tax collection.

## THE TASK FORCE'S DELIBERATIVE PROCESS

During organizational meetings in the summer and fall of 2008, the task force decided to form three specialized subcommittees: Prevention, Collaboration, and Enforcement. Each member of the task force served on one of those subcommittees, which met frequently during the intervals between the task force's own quarterly meetings.

The three subcommittees' names reflected their assignments. The Prevention Subcommittee looked for ways to discourage people from entering the underground economy, and to encourage those already involved to return to fully legal endeavors. The Collaboration Subcommittee explored ideas for improving cooperation between levels of government, within each level of government, and between governments and citizens. Finally, the Enforcement Subcommittee evaluated methods for detecting, thwarting, and punishing underground economy activity.

The task force met at quarterly intervals from 2008 through 2010 to receive updates on the subcommittees' ongoing work. In addition, at the task force meetings, all members had an opportunity to make presentations about their professional backgrounds and their encounters with various aspects of the underground economy. A glance back at the task force roster on pages ii and iii will show why those presentations were so informative. All the members acquired valuable new knowledge by listening to their comparably qualified colleagues who view the underground economy phenomenon from differing professional perspectives.

To better inform the subcommittees' discussions, the subcommittee chairpersons and members of the task force's support staff met regularly with the Board of Directors of the Referees Association of Michigan (RAM). In Michigan's judicial system, appointed domestic relations referees are the frontline jurists who actually listen to most of the live testimony in child support disputes. A referee usually conducts a relatively informal hearing and then

recommends a support order for review and entry by the elected judge to whom the case is assigned. All three subcommittee reports reflect suggestions and comments by the RAM Board of Directors.

The task force also received valuable input from the responses to a survey that it distributed to more than 2,500 state child support personnel.<sup>19</sup>

All three subcommittees filed reports that their chairpersons formally presented to the entire task force. Those reports are included here as Appendix A (Prevention), Appendix B (Collaboration), and Appendix C (Enforcement). Each subcommittee report states several broad “Principles,” offers “Recommendations” based on each principle, and elaborates on each recommendation in a separate “Discussion.”

After receiving the subcommittee reports and hearing the supporting presentations, the task force then discussed each subcommittee’s recommendations. This overview report synthesizes the subcommittee recommendations and the subsequent task force discussions. All of the subcommittees’ principles and recommendations are presented below, but because the versions presented here are much abbreviated, we strongly recommend also reading the more detailed subcommittee reports in Appendices A, B, and C.<sup>20</sup>

## OUR RECOMMENDATIONS

### PREVENTION RECOMMENDATIONS<sup>21</sup>

#### *Introduction by the Prevention Subcommittee*

Some noncustodial parents consciously reject responsibility for their children and make a “strategic” choice to enter the underground economy in order to avoid paying child support or taxes. For many noncustodial parents, however, the decision to enter the underground economy is “reactive.” The latter group goes underground because, due to their own inaction, ignorance, or avoidance, the support arrearage has become too large for them to pay, often before they first actually receive a demand for payment. Collecting support money from the

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<sup>19</sup> As used in the text above, “child support personnel” includes all state and local officials who help to administer Michigan’s child support program, including executive branch OCS caseworkers, judicial branch referees and Friend of the Court employees, local prosecutors, and some attorneys who specialize in this area.

<sup>20</sup> The subcommittee reports include some specific discussion of Michigan laws and concerns. The task force hopes that even those sections will lend themselves to application by analogy in other states.

<sup>21</sup> See Appendix A for the full report by the Prevention Subcommittee.

“strategic” nonpayer group will require enhanced enforcement efforts. But the larger “reactive” group and their children can benefit from preventive measures.

The Prevention Subcommittee’s stated principles and the recommendations derived from those principles aim to keep noncustodial parents out of the underground economy and to draw back those who already work underground. The recommendations focus on three broad concepts. First, identify and eliminate counterproductive enforcement mechanisms that drive support payers into the underground economy. Second, intervene early and aggressively in cases where the noncustodial parent appears likely to go underground. Third, offer mitigating incentives to encourage underground economy workers to emerge, obtain regular employment, and resume paying support.

**PREVENTION PRINCIPLE 1:** We must dramatically reduce the number of *default* support orders.

*Recommendations for Prevention Principle 1:*

1A: To avoid counterproductively causing noncustodial parents to accrue impossibly large arrears, we should require that, in *nonparticipating-defendant* default judgment cases, courts must: (a) set the current support amount based on reliable evidence of the noncustodial parent’s actual ability to pay; (b) issue a show cause order requiring the defendant to appear in court and produce evidence of actual income or ability to earn income; (c) order the defendant to utilize government-sponsored employment services; and (d) set the case for automatic review of the child support amount one year after entry of the default judgment.

1B: Engage noncustodial parents proactively as soon as a case is filed, and keep them engaged as long as the support case remains open.

1C: Using the Child Support Enforcement Annual Data Report (OCSE-157), track separately the collections and other performance measures in *nonparticipating-defendant* default judgment cases. If, as we expect, the data show lower collections in those cases, OCSE should reward states that have lower percentages of *nonparticipating-defendant* default judgments or states that are able to turn these judgments into regularly paying cases.

1D: Modify state paternity affidavit statutes (and the corresponding federal statute, if necessary) to require government-funded paternity testing of the mother, the child, and the identified father before giving legal effect to a signed paternity affidavit. If testing

shows that the man is not the biological father, the paternity affidavit should be deemed invalid. Only a court order then could designate legal parentage. Alternatively, state legislatures should enact statutes that provide clear guidance to the courts regarding how to “disestablish” paternity.

1E: Before using imputed income to establish an unemployed individual’s support obligation, require jurists to consider entering a graduated child support order in which the amount of imputed income gradually increases over time; e.g., impute 20 hours of work per week for the first six months, 30 hours per week for the next six months, and full-time work after one year. A graduated imputation of income will provide an incentive for noncustodial parents to accept jobs that don’t pay as much as their prior employment.

**PREVENTION PRINCIPLE 2:** Early intervention is critically important. Child support agencies must intervene *before* non-modifiable arrearages become so large that noncustodial parents can’t possibly catch up.

*Recommendations for Prevention Principle 2:*

2A: Identify high-risk support obligors at the earliest possible stage.

2B: Educate parents about their societal support obligations, their legal support obligations, and the court procedures in child support cases.

2C: Respond proactively and immediately when a support payer misses a scheduled payment.

2D: Require employers to submit new employees’ names to a central data base. Require the same reporting from all “sources of income” that make first-time payments to “independent contractors” and other service providers that the payer does not classify as “employees.”

2E: Educate parents on the processes and consequences of establishing and enforcing a child support order. In addition to more traditional methods, this effort should reach out to parents through media such as call-in radio shows, podcasts, YouTube, Facebook, and other current technologies.

**PREVENTION PRINCIPLE 3:** *Indigent* prisoners and jail inmates should not accrue any additional support arrears until they regain their freedom and the ability to earn income.

*Recommendations for Prevention Principle 3:*

3A: Require that IV-D and corrections personnel collaborate *before* sentencing to: (a) estimate the probability that the judge will impose a jail or prison sentence; (b) if incarceration seems likely, determine whether the defendant has any court-ordered child support obligations; and (c) follow through as needed to reduce an indigent defendant's support obligation (usually to zero) for as long as the defendant remains incarcerated. Additionally, use Title IV-D funds to hire new state-level child support staff to work at prison intake centers, identify support obligors entering the prison system, and facilitate support modifications.

3B: For indigent noncustodial parents who are current prisoners, initiate a permanent program patterned after the Michigan Friend of the Court Bureau's successfully pilot-tested "Prisoner Support Adjustment Project."<sup>22</sup>

**PREVENTION PRINCIPLE 4:** To the fullest extent allowed by federal law, we should implement relief-from-judgment processes that allow noncustodial parents to forestall arrearage enforcement if they pay current support. The goal should be to "manage" the arrears so that unpaid past support does not become an obstacle to paying current support and maintaining a parent-child relationship.

*Recommendations for Prevention Principle 4:*

4A: Propose federal and state legislation allowing courts discretion to cancel arrears owed to custodial parents.

4B: Experiment with allowing courts to adjust arrearages owed to custodial parents if the court gives notice of the proposed compromise to the custodial parent and that parent does not object.

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<sup>22</sup> Interested persons can obtain a report summarizing that pilot project from the Michigan State Court Administrative Office, Friend of the Court Bureau or the federal Office of Child Support Enforcement. A summary of the report is available at <http://www.acf.hhs.gov/programs/cse/pol/DCL/2009/dcl-09-26a.pdf>, on page 39.

4C: Propose legislation authorizing courts or IV-D agencies to approve payment plans under which a noncustodial parent can forestall aggressive efforts to collect arrears by regularly paying current support and (to the extent possible) reducing the arrears.

4D: For indigent parents, either waive the fees for support-modification motions or suspend the fees contingent on the motion's success. To the extent that current fee-waiver rules already allow this, IV-D agency offices should publicize that fact.

**PREVENTION PRINCIPLE 5:** Litigation procedures should encourage a future cooperative relationship between the parents because doing so will enhance the noncustodial parent's motivation to pay child support.

*Recommendations for Prevention Principle 5:*

5A: Improve the advocacy for noncustodial parents who cannot afford counsel and do not understand the judicial system or child support laws.

5B: Expedite the move toward "non-adversarial" procedures for domestic relations cases.

**PREVENTION PRINCIPLE 6:** Any practices that successfully prevent parents from entering the underground economy should be created locally and shared nationally.

*Recommendations for Prevention Principle 6:*

6A: Create state-specific and national "best practices" repository websites on which front-line child support workers can share strategies for combating the underground economy.



## COLLABORATION RECOMMENDATIONS<sup>23</sup>

### *Introduction by the Collaboration Subcommittee*

Parents who work in the underground economy earn income that escapes detection by the government agencies charged with collecting taxes and enforcing child support orders. Often acting with a specific intent to avoid meeting those financial obligations, underground economy workers either fail to report their income or significantly underreport it. That makes it difficult for courts to calculate appropriate child support amounts, and difficult for child support agencies to enforce the courts' orders.

In a world of unlimited resources, a coordinated government investigation usually could uncover the unreported income of any one individual. But in this real world of very limited resources, even the IRS can investigate only a small number of cases and hope that those audits (some targeted and some random) will deter mass noncompliance. If the IRS cannot investigate the majority of individuals who deliberately evade taxes, then state child support enforcement agencies obviously cannot investigate everyone who owes child support.

In most cases, however, several government agencies or private financial institutions have fragmentary information that, if combined and fully analyzed, might allow an investigator to discover unreported income. That potential for discovery exists because underground-economy income seldom remains totally and continuously invisible as an employer pays the money and a worker receives, spends, or invests it. But the income's temporary visibility to a single agency or financial institution can lead to higher child support collections only if all government and private entities systematically communicate with each other. In other words, they need to *collaborate*.

**COLLABORATION PRINCIPLE 1:** Improve information sharing between state and local agencies.

### *Recommendations for Collaboration Principle 1:*

1A: All circuit courts in Michigan should send their case data to the Judicial Data Warehouse (JDW). That would give the JDW a true statewide case-information database that authorized IV-D personnel could access when they need to locate support obligors.

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<sup>23</sup> See Appendix B for the full report by the Collaboration Subcommittee.

1B: MiCSES (Michigan Child Support Enforcement [computer] System) and the JDW should have a written data sharing agreement that allows personnel from the executive branch (OCS/MiCSES) and the judiciary (FOC/JDW) to access each other's data for specific establishment and enforcement purposes outlined in the agreement.

1C: The state IV-D agency should have access to, and should utilize, the search capabilities of state and municipal retirement systems.

1D: All insurance carriers should be required to participate in a data-match program such as Rhode Island's Child Support Lien Network or the federal OCSE's Insurance Company Data Match.

1E: When a lawsuit against the state results in a child support obligor obtaining a money judgment, state IV-D personnel should have an opportunity to collect any support arrears from the judgment proceeds before the state satisfies the judgment by paying the support obligor.

1F: IV-D personnel should have access to utility companies' customer data.

1G: Improve the processes for notifying IV-D personnel immediately when a support obligor enters or leaves prison or jail.

**COLLABORATION PRINCIPLE 2:** Expand information sharing between state and federal agencies.

*Recommendations for Collaboration Principle 2:*

2A: The federal Immigration and Customs Enforcement agency (ICE) may share with other law enforcement agencies information that ICE obtains during a criminal investigation. State attorneys general should establish formal tax and child-support collaboration agreements with ICE.

2B: IV-D personnel should ask support obligors to sign IRS Form 8821, which will authorize the IRS to provide copies of the obligor's tax returns and other communications between the IRS and the obligor.

2C: The federal OCSE and the Social Security Administration should develop a protocol for sharing and disseminating the SSA's annual summaries of individuals' reported income and projected benefits.

2D: Allow IV-D personnel to monitor a support obligor’s pending application for Social Security Disability Insurance benefits, and then issue an income withholding order immediately if the SSA awards benefits.

**COLLABORATION PRINCIPLE 3:** Local IV-D agency offices should think creatively and act on a grassroots level to penetrate the underground economy in their local communities.

*Recommendations for Collaboration Principle 3:*

3A: Hire “field investigators” to assist local IV-D personnel by investigating disputed factual issues and performing other investigative work as needed.

3B: Create *local* multi-agency and multi-disciplinary underground economy “teams.”

3C: Collaborate with local business people and labor unions to discover businesses that either pay their employees in cash or “misclassify” their employees as independent contractors.

3D: Create a state-wide Underground Economy Investigation Protocol.

3E: Train police officers on how to obtain usable information from child support obligors whom the officers stop for traffic violations and then detain at the scene after discovering that the person has a nonsupport bench warrant that requires a court appearance.

## ENFORCEMENT RECOMMENDATIONS<sup>24</sup>

*Introduction by the Enforcement Subcommittee*

Given the nature of the problem, no combination of enforcement methods will ever completely eradicate the underground economy. Nonetheless, we can enhance our enforcement of the tax and child support laws with methods that either attack the entire underground economy or precisely target some participants.

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<sup>24</sup> See Appendix C for the full report by the Enforcement Subcommittee.

Our objective should be to impede and punish underground economic activity by deploying an array of enforcement techniques that make doing business underground so difficult and costly that *most* people who engage in *financially significant* underground transactions will eventually conclude that operating legally better serves their own interests.

**ENFORCEMENT PRINCIPLE 1:** Child support obligors now working in the underground economy will respond best to external influences and early intervention.

*Recommendations for Enforcement Principle 1:*

1A: Enact a new statute or court rule that confirms and defines judges' authority to issue "pay or stay" orders that include an automatically recurring ultimatum that support obligors pay a certain amount of support by a specified deadline or spend the next weekend either in jail or with their movements restricted by a less expensive alternative such as an electronic tether.

1B: Courts and IV-D agencies should require divorcing parents to attend pre-judgment educational programs. For never-married parents, similar programs should be offered, but not mandated.

1C: Each local IV-D agency office should dedicate specific staff resources to closely monitoring cases in which the court either established or significantly modified the support obligation within the previous six months.

1D: Use public scrutiny (e.g., targeted "wanted poster" mailings) to locate support obligors and their assets within the underground economy.

1E: Use an automated system to call delinquent obligors' cell phones and play a recorded message reminding them to pay their support arrears.

1F:<sup>25</sup> Use special color-coded paper for important enforcement documents to ensure that people read the forms.

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<sup>25</sup> This is Recommendation 3D in the Enforcement Subcommittee's original report.

**ENFORCEMENT PRINCIPLE 2:** Our efforts to collect child support and unpaid taxes from underground economy workers must include techniques that accurately identify those underground economy workers who earn significant incomes.

*Recommendations for Enforcement Principle 2:*

2A: Use information from the federal government (e.g., passport and customs records) to identify international travelers who have failed to pay child support or tax debts.

2B: Child support collections staff should receive specialized training on IRS techniques for investigating tax evasion.

2C: Assign selected IV-D or state tax personnel to investigate local underground economy activity.

2D: Ask local community members to identify underground economy workers.

2E: Reach out to potential allies such as labor unions and law-abiding businesses who are harmed by the underground economy in ways not directly related to either taxation or child support.

2F: Enact clear statutory authority (“notwithstanding any other law to the contrary”) for state IV-D and tax agencies to obtain wages-paid information from any public or private entity if the information will aid in the enforcement of a tax or child support obligation.

**ENFORCEMENT PRINCIPLE 3:** Strengthen other existing statutes, court rules, and professional ethical codes to allow better enforcement of our tax and child support laws.

*Recommendations for Enforcement Principle 3:*

3A: Enact legislation requiring state-licensed casinos to check a child support arrearage data base before paying jackpot winners. When a casino finds a match, it should pay its customer only the difference (if any) between the jackpot win and the support arrears debt. The remaining money should be remitted to the appropriate Title IV-D agency.

3B: Allow the state child support system to escrow and administer lump-sum surety bonds that guarantee the payment of future support by support obligors who have significant current assets, but doubtful prospects for earning future income.

3C: Coordinate all state government license-issuing agency websites and data bases so that a single online search can discover all state licenses held by a support obligor.

3D:<sup>26</sup> Enact federal legislation that unequivocally authorizes Title IV-D agencies and state tax departments to use consumer credit reports for enforcement purposes.

3E: Amend the notice requirements in state felony nonsupport laws to allow a felony prosecution even if the support obligor was not personally served in the underlying civil case that established the support obligation.

3F: Harmonize state felony nonsupport statutes and restitution statutes to clarify two points. First, a defendant convicted of felony nonsupport must pay restitution that includes the support arrears owed on the underlying civil support order. Second, a restitution order in a felony nonsupport case does not affect the underlying support order or the authority of the state's IV-D personnel to enforce the support order.

3G: In felony prosecutions involving a seizure of assets that are subject to forfeiture if the defendant is convicted, prosecutors and other IV-D personnel should collaborate to determine whether the defendant owes child support arrears. If so, the IV-D agency should prepare to levy on the assets immediately in the event that the criminal prosecution does not result in a conviction and forfeiture.

3H: Modify the forfeiture laws to allocate some forfeiture proceeds to pay the property owner's past-due taxes and child support.

3I: Match child support records with a state's quarterly wage reports and automatically issue income withholding notices based on matching data entries.

3J: Provide guidance to jurists regarding whether they must report (to tax authorities) information about a person's underground economy income that the jurist learns while conducting a hearing to establish or modify child support.

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<sup>26</sup> The Enforcement Subcommittee's original Recommendation 3D appears as Recommendation 1F in this report. The other recommendations under Principle 3 have been re-lettered in the text above to adjust for that transfer.

**ENFORCEMENT PRINCIPLE 4:** New special-purpose statutes targeting the underground economy will provide effective new enforcement tools. [NOTE: The phrasing of the following recommendations by the Enforcement Subcommittee assumes the passage of appropriate enabling legislation.]

*Recommendations for Enforcement Principle 4:*

4A: “Boot” cars owned by parents who owe child support arrears.

4B: Confiscate season tickets to sporting events, resell the tickets, and use the proceeds to pay support arrears and delinquent taxes.

4C: Data-match child support records with cell phone providers’ subscriber lists.

4D: Cross-check support obligors’ federal, state, and local income tax returns. Also examine local property tax records. Investigate any inconsistencies.

4E: Anyone selling merchandise at a location other than a permanent store must obtain and prominently display a license showing that the business has been registered with an appropriate governmental unit.

**ENFORCEMENT PRINCIPLE 5:** Employers should be discouraged from enabling the underground economy.

*Recommendations for Enforcement Principle 5:*

5A: Confiscate and revoke the business licenses of employers who pay their employees in cash and do not report the payments *properly* on tax forms filed with the federal, state, and local tax agencies.

5B: Require employers who intentionally misclassify their workers, or who make unreported cash wage payments, to assume the workers’ obligations for the resulting underpayments of taxes and child support. That new obligation would be in addition to the employers’ own original obligation to pay taxes, insurance premiums, and other costs of doing business legally. To encourage violation reports, the new law should include whistleblower protections for employees who report their employers.



## CONCLUDING STATEMENT

The underground economy is a pervasive and complex social problem that requires systematic study. A continued, thorough exploration of this still mostly uncharted territory remains essential to better enforcement of our child support and tax laws.

This report offers recommendations to governments at the local, state, and federal levels. Some recommendations could be implemented immediately. Some may require specific authorizing legislation. Others may languish for lack of funding. And some will become the subjects of vigorous debates about their wisdom. No member of this task force believes that the underground economy would disappear, even with the adoption of all these recommendations. We hope, however, that we have advanced the search for solutions to the underground economy problem.

We acknowledge that many people who work in the underground economy do not earn enough to pay their debts, and some struggle just to support themselves. But every member of our task force understands the importance of bringing these individuals aboveground and making them active members of their families, our society, and our economy. Therefore, we have not focused exclusively on collections and enforcement. Some underground parents feel, with justification, that they were forced into the underground economy by an excessive child support order or an insurmountable debt. We should offer these parents reasonable means of debt relief and encourage them to come into the fold, to become true parents to their children, and to reconcile with their families. But none of those good things can happen unless we first *find* the parents so we can begin to engage them in discussions about their ability and responsibility to support their children.

# GLOSSARY OF TERMS

Before proceeding, those readers who are not familiar with child support enforcement matters or the structure of Michigan state government should note the following acronyms that will appear throughout this report.

**FOC:** The “Friend of the Court.” In Michigan, this judicial agency provides Title IV-D assistance to families and the trial courts.

**MiCSES:** The “Michigan Child Support Enforcement System.” This is the centralized computer system that contains the data from all of Michigan’s Title IV-D cases. It also tracks the progress of those cases, alerts enforcement workers to emerging problems, and automatically generates many enforcement documents.

**NCP:** Non-custodial parents. While a child’s parents may have joint custody, in the Title IV-D lexicon, the acronym “NCP” describes a parent obligated to pay child support through the Title IV-D agency to the custodial party (the “CP”).

**OCS:** The “Michigan Office of Child Support.” This division of the Michigan Department of Human Services, part of the executive branch, is Michigan’s designated Title IV-D agency. OCS serves as Michigan’s link to the federal government’s child support agency, receives nearly all of Michigan’s federal child support funding, coordinates the state’s support-enforcement efforts, and maintains MiCSES.

**Title IV-D workers:** This term includes all Title IV-D personnel in Michigan who provide IV-D services including the establishment and enforcement of child support orders. This includes FOC staff who enforce the order of the court, prosecuting attorneys who establish the support and may criminally prosecute those who don’t comply, and OCS central staff. Title IV-D refers to Title IV, Section D of the Social Security Act, the federal statutes governing child support.

UNDERGROUND ECONOMY TASK FORCE

**APPENDIX A: PREVENTION SUBCOMMITTEE REPORT**

June 3, 2009, updated May 2010

**SUBCOMMITTEE MEMBERS**

**MEETINGS**

Hon. Chad C. Schmucker, Chair

October 10, 2008

James Long (AAG)

November 14, 2008

Marilyn Stephen (OCS)

December 3, 2008

Dan Wright (SCAO Staff Support)

December 12, 2008

Ken White (SCAO Staff Support)

February 13, 2009

March 27, 2009

April 5, 2010

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**INTRODUCTION**

Some noncustodial parents consciously reject responsibility for their children and make a “strategic” choice to enter the underground economy in order to avoid paying child support or taxes. For many noncustodial parents, however, the decision to enter the underground economy is “reactive.” The latter group goes underground because, due to their own inaction, ignorance, or avoidance, the support arrearage has become too large for them to pay by the time they actually receive a demand for payment. Collecting support money from the “strategic” nonpayer group will require enhanced enforcement efforts. But the larger “reactive” group and their children can benefit from preventive measures.

This report summarizes the Prevention Subcommittee’s recommendations for keeping non-custodial parents out of the underground economy and drawing back those who already work underground. When formulating these prevention recommendations, we focused on three broad concepts. First, identify and eliminate counterproductive enforcement mechanisms that mostly serve to drive support payers into the underground economy. Second, intervene early and aggressively in cases where the non-custodial parent appears inclined to go underground. Third, offer mitigating incentives to encourage underground economy workers to emerge, obtain regular employment, and resume paying support.

In the sections that follow, this report states some general principles of prevention. Each principle introduces several recommendations. A brief discussion follows each recommendation.

## **PRINCIPLES AND RECOMMENDATIONS**

**PRINCIPLE 1:** We must dramatically reduce the number of *default* support orders.

**Recommendation 1A:** In *nonparticipating-defendant* default judgment cases, require courts to:

(a) set the current support amount based on reliable evidence of the NCP's actual ability to pay; (b) issue a show cause order requiring the defendant to appear in court and produce evidence of actual income or ability to earn income; (c) order the defendant to participate in the Work First program or a similar employment service; and (d) schedule an automatic review of the order one year after entry.

**Discussion 1A:** Default support orders are penny wise but pound foolish. For courts and enforcement agencies, they solve the initial problem of establishing support, but they eventually cause other, often bigger problems.

If no one can present evidence of the non-custodial parent's actual ability to pay, then the established support has no basis in fact. Further, most defaulted non-custodial parents have no actual notice of the support obligation. An NCP without notice is virtually certain to accrue a support arrearage. As the arrearage grows, it becomes ever more likely that the NCP will not be able to pay the arrearage when eventually located and notified. As explained in this report's introduction, NCPs confronted unexpectedly with an arrearage that already exceeds their ability to pay may enter the underground economy to escape what they consider an unfair and economically crippling liability.

Further, when a court issues a child support order, it often takes three years before any government agency will initiate a review to determine if the order should be modified. Requiring an earlier, automatic review will reduce the likelihood of unpayable arrears accruing and driving a parent underground.

The Task Force instructed our subcommittee to propose methods that will prevent NCPs from entering the underground economy. This recommendation would do that. We realize that it will not be possible to entirely eliminate default orders, and we know that most prosecutors and FOCs already make diligent efforts to unearth the truth about NCPs and to get support orders "right sized" from the outset. We also recognize that ordering only nominal support in the absence of ability-to-pay evidence could incentivize some NCPs to

*not* cooperate precisely because that may force the court to order only nominal support. Obviously, implementing this recommendation will require some careful balancing, including protections for custodial parents, but our goal should be to dramatically reduce the number of default support orders.

**Recommendation 1B:** Engage non-custodial parents proactively when a case is filed, and keep them engaged throughout.

**Discussion 1B:** We often end our proactive communication efforts after handing a summons to the NCP, calculating that the burden then shifts to the NCP to appear in court and help the court establish an appropriate support amount. But many NCPs ignore the summons, which leads to the court entering a default order that has the adverse effects already summarized.

Going beyond merely serving the summons will advance the goal of avoiding default orders. For example, Wayne County recently completed a pilot project that used specially trained and financially incentivized process servers who would “stop and talk” with putative fathers after serving a paternity summons. Among other things, the process servers tried to get accurate contact information. Later, court personnel followed up by telephone to establish and maintain contact with the defendants, inform them about court processes, and encourage them to appear and participate. When the process servers actually spoke with putative fathers, only 31% of cases concluded with the entry of a default order. That contrasts to a 61% default rate in control group cases that did not benefit from special handling. In addition to reducing defaults, the project also increased compliance rates because, as many studies have demonstrated, NCPs who participate in the court proceedings to establish paternity and support are far more likely to comply with support orders.

*A caveat:* The Wayne County program summarized above was a specially funded pilot project. Lacking new funding, the county could not continue the extra communication efforts. But the successful pilot project proves the value of actively engaging NCPs, and it provides one specific example of how to do that.

Parenthetically, one important lesson learned from the Wayne County experiment involves the importance of obtaining an NCP’s cell phone number. The trend away from land lines is even more pronounced at lower income levels, but “all” NCPs have some kind of cell service. Local offices could use this phone number to call NCPs in advance of a hearing or immediately after a default judgment is entered. Alternately, MiCSES could be programmed to auto-dial the number and leave a recorded message reminding the NCP of the need to attend the hearing, or to object to the order if the NCP did not appear.

Michigan court rules (MCR 2.402, 3.210, 3.215, and 3.923) allow for remote attendance at civil hearings, but not all courts have communication equipment in the hearing room. Therefore, the current practice is inconsistent in terms of both use and practicality. The subcommittee recommends that courts streamline the ability to appear telephonically at hearings by investing in the proper equipment.

**Recommendation 1C:** Use the Child Support Enforcement Annual Data Report (OCSE-157) to *separately* track the collections and other performance measures in *nonparticipating-defendant* default judgment cases. If, as we expect, those data show lower collections in those cases, OCSE should reward states that have lower percentages of *nonparticipating-defendant* default judgments or turn these judgments into regularly paying cases.

**Discussion 1C:** Organizations tend to change only the things they monitor. The National Judicial-Child Support Task Force published the results of a survey that focused on default order entry procedures.<sup>27</sup> It revealed that no responding state's computer system tracks nonparticipating-defendant default orders separately from other orders. Therefore, we currently have no way to measure states' performance in that category of cases. However, most survey respondents assumed that nonparticipating-defendant default cases have lower collection rates and generally present more difficult collection problems.<sup>28</sup> By tracking actual collections data for the category, we could test that assumption.

The OCSE-157 report already tracks the caseload for each state's IV-D program. That report provides data on collections of both current support and arrears. The current OCSE-157 will expire in 2011, and must be republished before renewal by the Office of Management and Budget (OMB). The post-2011 version should include data subsets for *nonparticipating-defendant* default orders and the corresponding amounts of current and past-due support actually paid. The results will provide IV-D directors with important management information about these cases—and probably confirm the survey respondents' assumptions about the realities of enforcing default support orders.

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<sup>27</sup> See Setting Appropriate Child Support Orders: Practical Techniques Used in Child Support Agencies and Judicial Systems in 14 states, August, 2007. Published by OCSE in Dear Colleague Letter 2009-15, located at <http://www.acf.hhs.gov/programs/cse/pol/DCL/2009/dcl-09-15a.pdf>.

<sup>28</sup> See question and answer 19 and 20, *id.*

Reliable data on nonparticipating-defendant cases will allow states to accurately quantify the impact of their current default procedures and take appropriate action to avoid creating insurmountable arrears.

Finally, OCSE should consider rewarding states that have low percentages of nonparticipating-defendant default orders rate. This subcommittee recognizes the difficulty of establishing a new federal *performance-measure incentive*, so we have not recommended that. However, providing *some* financial reward to states that have low nonparticipating-defendant default order rates will motivate states to keep that percentage as low as possible.

**Recommendation 1D:** Modify the acknowledgment of parentage act (MCL 722.1001, et. seq.) (and corresponding federal statute [ref. 42 USC 666(a)(5)(C)], if necessary) to require government funded paternity testing of a mother, her child, and the identified father before giving legal effect to a signed paternity affidavit. If testing shows that the man did not father the child, the paternity affidavit should be disregarded. Only a court order then could designate legal parentage. Alternatively, the legislature should provide clear guidelines for disestablishing paternity.

**Discussion 1D:** We realize some people will object a requirement that that they prove their biological relationships. The requirement could stress a potential new family shortly after the birth of a child. And many will have privacy concerns about the state collecting and testing genetic material before accepting a paternity affidavit. The task force heard and debated those arguments; a clear majority of the members support this recommendation.

Some task force members have heard from “legal” fathers who signed a paternity affidavit years earlier, sometimes under intense pressure from the child’s mother or her family. These men call after learning much later that they are not the biological fathers. They want to know “how to get out” of their support obligations. The majority of the task force believes that a definitive biological determination of paternity should be made at the earliest possible date, so courts aren’t asked to revoke that affidavit later. The government should pay for this mandatory testing with a combination of state and federal IV-D funds.

We know that non-biological father sometimes sign paternity affidavits to accomplish a “poor man’s adoption,” thereby avoiding the need for more formal adoption procedures that involve investigations and multiple hearings. Signing a paternity affidavit is a quick and relatively cost-free alternative. Our recommendation would remove that option, and some will oppose the recommendation for that reason, but we believe that it is more important to protect the rights of voluntary fathers, biological fathers (if different), and children (who may have a right to know who is their biological father). If genetic testing does disprove the



paternity affidavit, the potential father still may ask a court to establish legal parenthood. But the court then can take steps to protect the rights of the actual biological father and the child.

If the legislature decides not to require immediate paternity testing before recognizing a paternity affidavit, the subcommittee alternatively recommends that the legislature establish a judicial process for disestablishing paternity at a later date. The current lack of statutory guidance has led to courts having varied procedures. Clear statutory guidance would provide needed uniformity.

**Recommendation 1E:** The Michigan Child Support Formula (MCSF) should require that jurists who intend to use imputed income to establish an unemployed individual's support obligation first consider entering a graduated child support order in which the amount of imputed income gradually increases over time. For example, the jurist might impute 20 hours of work per week for the first six months, 30 hours per week for the next six months, and full-time work after one year. A graduated imputation of income will provide an incentive for noncustodial parents to accept jobs that do not pay as much as their prior employment.

**Discussion 1E:** When applying the child support formula, courts may impute income when they find that an unemployed parent could have earned that income, but chose not to. Imputing a part-time wage at first will incentivize an unemployed parent to accept a lower-paying job quickly, rather than “hold out” for a dream job. Increasing the imputed amount gradually should prove more effective than immediately imputing a full-time wage to a parent who doesn't currently have any job; the all-or-nothing approach may serve only to build up an arrearage and drive the unemployed parent into the underground economy.

The task force makes this recommendation despite knowing that, in Michigan's current economic crisis, few people will reject any job offer. Nevertheless, to better protect children by providing maximum incentives for parents to find employment, the task force recommends that jurists consider using this graduated imputation practice.

**PRINCIPLE 2:** Early intervention is critically important. Child support agencies must intervene *before* non-modifiable arrearages become so large that NCPs can't possibly catch up.

**Recommendation 2A:** Early identification of high-risk support obligors.

**Discussion 2A:** We should “triage” or “profile” new cases to predict which NCPs will be cooperative payers and which will require special attention because they seem likely to attempt avoidance. Examples include all default orders and most orders that do not identify

a source of income for the NCP. We can use automated case sorting to assign the potentially difficult files to caseworkers who specialize in a particular category of payer. Those caseworkers should handle fewer files so they will have the extra time required to monitor problematic NCPs.

In this time of diminished resources, automated case sorting also can help to identify cases whose high degree of difficulty indicates that we should *not* make extraordinary enforcement efforts. That is a sad reality, but ignoring it would waste scarce resources, reduce total child support collections, and thus help fewer children.

**Recommendation 2B:** Educate parents about support obligations and court procedures.

**Discussion 2B:** The educational efforts should focus most intensely on noncustodial parents who: (1) were recently ordered to pay child support; (2) currently have a small or zero arrearage; and (3) already have some involvement with the underground economy or are positioned to enter it.

We should emphasize parents' moral and legal duties to support their children, and also the financial and legal consequences of ignoring support orders. The IRS stresses reporting income, but even people who fail to report taxable income may pay child support if they have a concept of "family" that focuses on their children and their parental responsibilities.

Concurrent with the entry of each support order, parents should also receive written instructions about how to request a support modification if their circumstances change. That will enable them to seek appropriate relief if they encounter financial problems that prevent them from paying the originally ordered support amount. The instructions should include information on how to request a fee waiver for a support-modification motion if the friend of the court does not initiate the modification process.

**Recommendation 2C:** Respond proactively and immediately to missed support payments.

**Discussion 2C:** If an arrearage grows to the point that NCP cannot possibly catch up, that NCP may see the underground economy as the only viable escape option. For a low-wage NCP who has no savings, even a few months' arrearage may be too much to overcome. Therefore, as soon as it becomes clear that the NCP is not paying the current support, we should contact the NCP, find out what has happened, and try to make alternative payment arrangements.

The obstacle here is, of course, resources. IV-D agencies will need additional staff in order to respond more quickly to missed payments. To cite just one example, it now takes the Wayne County FOC office several months to process a support review. Realistically,

Michigan’s current budget situation will not allow us to increase IV-D agency budgets. That fact makes it even more imperative that we develop the automated case-triage processes recommended in Discussion 2A.

**Recommendation 2D:** Require employers to submit new employees’ names to a central data base. Require the same of “sources of income” who make payments to “independent contractors.”

**Discussion 2D:** Federal law already requires employers to report all newly hired employees within 20 days of hire. MiCSES automatically uploads this information and compares the employees’ names to those of support obligors. When MiCSES finds a match, the system automatically sends a standard income withholding order to the employer.

That system works well only if employers comply with the reporting requirement. OCS has a New Hires Operations Center that compares data bases and contacts employers who are not complying with the federal new-hire reporting requirements. But the current detection and enforcement processes are not ideal. OCS would prefer to have a Michigan “New Hire” law that tracks the federal law.

Michigan legislation could also require that “sources of income” for “independent contractors” must report those contractors’ names. Increasingly, businesses and workers that traditionally had employer-employee relationships are switching to contract arrangements in order to reduce costs, increase flexibility, and avoid obligations—*such as New Hire reporting*. To keep up, the laws governing child support enforcement must evolve apace.

**Recommendation 2E:** Educate parents on the processes for establishing and enforcing a child support order. The instructional effort should embrace both traditional media resources, like call-in radio shows, and newer media such as podcasts, YouTube, and Facebook.

**Discussion 2E:** Our child support establishment and enforcement processes can appear convoluted and hard to understand. But this state’s child support program directly touches approximately 2.5 million people, a quarter or more of all Michigan residents. The task force supports educating people about the system. Call-in radio programs in other jurisdictions have benefited the local child support agencies and their communities. Those shows are staffed by knowledgeable IV-D personnel or local family-law attorneys. Alternative media such as podcasts, YouTube, and Facebook can reach younger, more digitally connected parents.

**PRINCIPLE 3:** *Indigent* prisoners and jail inmates should not accrue any additional support arrears until they regain their freedom and the ability to earn income.

**Recommendation 3A:** Require that the probation department and the friend of the court collaborate *before* sentencing to: (a) estimate the probability that the judge will impose a jail or prison sentence; (b) if incarceration seems likely, determine whether the defendant has any court-ordered child support obligations; and (c) follow through as needed to reduce an indigent defendant's support obligation (usually to zero) for as long as the defendant remains incarcerated. Alternatively, use IV-D funds to hire a new state-level staff person to work at the Department of Corrections intake center, identify support obligors entering the prison system, and facilitate support modifications.

**Discussion 3A:** An indigent NCP about to go to prison or jail will not have any ability to pay support until being released. But a support arrearage will accrue automatically if no one intervenes to modify the support order. For obvious reasons, few prisoners seek modifications themselves.

In almost all such cases, allowing an arrearage to accrue serves only two purposes, both bad. First, this is one path to the undesirable situation in which NCPs join the underground economy because they cannot possibly pay an accrued arrearage. Second, because they cannot catch up even after leaving prison or jail, Michigan's collection performance rating suffers and the state loses federal funding as a result.

The solution is to temporarily reduce the convicted NCP's support obligation to zero before or concurrently with the sentencing. This will require cooperation between that probation department, one or more friend of the court offices, and one or more courts (including district courts for misdemeanor sentences) in order to: (a) determine if the defendant is subject to support orders and, (b) if so, take the steps necessary to have the courts that issued the support orders reduce the ordered support to zero until the NCP completes the jail or prison sentence. Courts should require that their presentence reports include information about a convicted defendant's child support orders, including the issuing courts and the support-case docket numbers.

If this recommendation is adopted, we could ease the burden on probation departments and FOC offices somewhat by routinely giving an advice-of-support-rights document and a forms packet to all defendants who are sentenced to jail or prison. However, one clear lesson learned from the pilot-tested Prisoner Support Adjustment Project (discussed below in Recommendation 3B) is that prisoners often do not seek a support modification even when that requires nothing more than signing and mailing a form. Therefore, if only to protect the

state by reducing our uncollectable arrears total, we would still need a systemic process for handling most cases.

An even better solution would involve changing Michigan law to *mandate* automatic support reductions when an indigent support payer enters prison. Federal law appears to give states this option. See OCSE AT-89-06, Comment and Response No. 12. To win legislative approval, a bill making this change probably would have to exclude an NCP whose imprisonment results from an offense committed against either the custodial parent or a child of either parent.

Alternatively, a Title IV-D funded employee at the Department of Corrections intake center could address child support issues for parents just entering the prison system, including the need to modify a support order. This recommendation would provide a failsafe second level of scrutiny for newly incarcerated parents.

The subcommittee realizes that many well intentioned people will perceive support adjustments for prisoners as a reward for criminal behavior. That perception is not altogether unfounded but, for the reasons outlined above, adjusting a prisoner's support is the "least bad" option available to us.

**Recommendation 3B:** For indigent NCPs who already are prisoners, initiate a permanent program patterned after the Friend of the Court Bureau's successful Prisoner Support Adjustment Project.

**Discussion 3B:** Using federal grant funds, the FOCB pilot tested this idea in 2004-2006. It first cross-checked MiCSES and Department of Corrections data bases to identify prisoners who were subject to current support orders and accruing arrearages due to their indigence. Then the FOCB divided the prisoners' cases into groups and tried several different approaches for having the courts temporarily reduce the prisoners' support obligation. The most effective method by far was to give each FOC a list of its cases that involved current prisoners. The FOC office then reviewed the file and, if appropriate, filed a motion to modify the support order. We recommend that OCS and the FOCs establish a permanent program based on that model.

**PRINCIPLE 4:** To the fullest extent allowed by federal law, we should implement relief-from-judgment processes that will allow NCPs to forestall arrearage enforcement if they pay current support. The goal should be to "manage" the arrears so that unpaid past support does not become an obstacle to the NCP paying current support and maintaining a parent-child relationship.

**Recommendation 4A:** Propose federal and state legislation allowing courts some discretion to cancel arrears owed to custodial parents.

**Discussion 4A:** Our current laws' absolute insistence that an NCP of limited means pay both the current support and the entire arrearage illustrates the maxim that "perfect is the enemy of good." We need a safe middle ground where NCPs who step up and begin paying current support can earn some relief from an accrued arrearage that they never will be able to pay. Otherwise, our futile efforts to collect arrearages will only drive NCPs into the underground economy, thereby also assuring that those NCPs will not pay any current support.

Ideally, the law would allow proposing a grand bargain that offers NCPs gradual arrearage forgiveness if they continue to pay current support. We already have some ability to forgive arrears owed to the state. But current federal law makes it very difficult to do anything about arrears owed to a custodial parent. Therefore, we recommend proposing a change in that federal law.

**Recommendation 4B:** Experiment with allowing Michigan courts to adjust arrearages owed to custodial parents if the court gives notice of the proposed compromise to the custodial parent and the CP does not object.

**Discussion 4B:** There is support in federal OCSE policy for modifying arrears owed to a custodial parent if the request is granted in accord with a state law that permits the modification of other civil judgments. We should advocate for clarifying both Michigan's court rules and statutes and the federal policy to clearly permit a waiver of arrears owed to the custodial parent in appropriate cases if the custodial parent fails to appear for a modification hearing after receiving actual notice of the hearing.

**Recommendation 4C:** Propose an improved Michigan law authorizing courts or IV-D agencies to approve payment plans under which an NCP can at least forestall aggressive efforts to collect arrears if the NCP regularly pays current support and (to the extent possible) reduces the arrears.

**Discussion 4C:** In theory, MCL 552.605e already allows this, but OCS reports that the existing procedure is cumbersome and needs to be streamlined so this option will be used more frequently. Several other states have effective laws that could serve as models. This concept provides "room to breathe" for NCPs who show good faith by consistently paying their current support obligation. In an ideal world, federal and state law would allow NCPs to earn forgiveness of their arrears in installments as they continue to pay current support.

**Recommendation 4D:** For indigent and borderline-indigent parents, either waive the fee for modification motions or suspend the fee contingent on the motion’s success. To the extent that current fee-waiver rules already allow this, FOC offices should publicize that fact.

**Discussion 4D:** Economic necessity has forced courts to increase most filing fees to levels that effectively deny access to the courts for people of limited means who do not qualify for fee waivers under current law. But if changed circumstances make a current support level too high, we actually want support payers to petition the court for a reduction; otherwise, the arrearage will grow so large that the NCP may enter the underground economy and pay no support. Therefore, we should either waive the filing fee for support modification motions or suspend the fee pending the court’s consideration of a motion. In the fee-suspension scenario, a full waiver might hinge on the court either: (a) granting the motion, or (2) denying the motion but ruling that the motion was neither frivolous nor duplicative.

**PRINCIPLE 5:** Litigation procedures should encourage a future cooperative relationship between the parents.

**Recommendation 5A:** Improve the advocacy for NCPs who cannot afford counsel and do not understand the judicial system or child support law.

**Discussion 5A:** If NCPs participate effectively in the court proceedings, this will yield more appropriate support orders and more consistent compliance. The state currently lacks the funding to even consider providing appointed attorneys; however, we should consider using volunteer court-appointed special advocates modeled on the CASAs who speak to and for children in child welfare cases.

**Recommendation 5B:** Expedite the move toward “non-adversarial” procedures for domestic relations cases.

**Discussion 5B:** Kent County recently began a pilot program that requires the cooperative drafting of parenting plans, mandates mediation, and modifies legal terminology. Our traditional litigation methods encourage parties to view each other as adversaries. That may be acceptable for cases whose parties will never see each other again post-verdict, but it causes problems in domestic relations cases involving children because the parents will have a compelled child-centered relationship for years to come. The court system should promote cooperative parental relationships. Even seemingly minor steps (like legal documents that identify the parties as “father” and “mother” instead of “plaintiff” and “defendant”) can take us a long way in that preferred direction.



**PRINCIPLE 6:** Agencies should share information about practices that prevent parents from entering the underground economy.

**Recommendation 6A:** Create a “best practices” repository that uses either an existing outlet or a new website. Front-line IV-D staff could use that repository to share methods that have helped them to combat the underground economy.

**Discussion 6A:** This recommendation could have appeared in any of the three subcommittee reports. Essentially, this subcommittee recommends that local jurisdictions report what has worked for them, and have easy access to information about what has worked for other jurisdictions. This ongoing reporting will keep efforts to address the underground economy in the forefront of people’s minds. It also will provide a venue to address new issues as they arise.

Respectfully submitted,

Hon. Chad C. Schmucker  
Chair, Prevention Subcommittee

UNDERGROUND ECONOMY TASK FORCE

**APPENDIX B: COLLABORATION SUBCOMMITTEE REPORT**

December 3, 2009

**SUBCOMMITTEE MEMBERS**

**MEETINGS**

Maurice Aouate (IRS), Chair

October 10, 2008

Hon. Maura D. Corrigan

October 29, 2008

Mary Lannoye

December 3, 2008

Russell Prins (AG)

March 11, 2009

Patrick O'Brien (AG)

April 1, 2009

Angel Sorrells (SCAO Staff Support)

May 5, 2009

Casey Anbender (SCAO Staff Support)

July 30, 2009

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**INTRODUCTION**

Parents who work in the “underground economy” earn income that escapes detection by the government agencies charged with collecting taxes and enforcing child support orders. Often acting with a specific intent to avoid meeting those financial obligations, underground economy workers either fail to report their income or significantly underreport it. That makes it difficult for courts to calculate appropriate child support amounts and for child support agencies to enforce the courts’ support orders.

The Internal Revenue Service recently estimated that the federal “tax gap” (unpaid federal taxes owed on unreported income) exceeds \$345 billion annually (\$290 billion after late-received payments and enforcement actions). Uncollected court-ordered child support currently totals \$109 billion nationally and \$9.2 billion in Michigan. No one can accurately estimate how much additional child support would be collected if parents reported all of their income, but having accurate income data obviously would lead to a significant increase in the total support ordered and collected.

A coordinated government investigation usually could uncover the unreported underground-economy income of any one individual. But a cost-benefit analysis precludes the IRS from investigating individuals unless the case involves a large delinquency and possibly significant assets. When it comes to modest- and low-income underground economy

workers, merely discovering a person's involvement in the underground economy presents a major first obstacle to finding unreported income. Because it is so difficult to identify nonreporting *workers*, the IRS focuses most of its investigative efforts on identifying *employers* who pay multiple workers "off the books." Despite the IRS's knowledge of the \$345 billion federal Tax Gap, not even that agency can afford the hours and money required to routinely investigate individuals' income, except for the randomly initiated investigations that serve primarily to deter mass noncompliance.

If the IRS cannot afford to investigate individuals, then Michigan's child support enforcement system obviously does not have the resources to do that.

Presently, that cost-benefit calculation remains valid even when several government agencies or private financial institutions have fragmentary information that (if combined and fully analyzed) would allow an investigator to quickly discover unreported income. That potential for discovery exists because only rarely will underground-economy income remain totally and continuously invisible as an employer pays the money and a worker receives, spends, or invests it. But the income's temporary visibility to a single agency or financial institution can boost child support collections only if governmental and private entities systematically communicate with each other. In other words, they need to *collaborate*.

In the sections that follow, this report states several collaboration principles. Each principle introduces several specific recommendations for better collaboration among government agencies or between government and the private sector. A brief discussion follows each recommendation.

## **PRINCIPLES AND RECOMMENDATIONS**

***PRINCIPLE 1:*** Improve information sharing between state and local agencies.

**Recommendation 1A:** All circuit courts in Michigan should send their case data to the Judicial Data Warehouse (JDW). That would give the JDW a true state-wide case-information database that all FOC line staff and certain OCS central staff could access when they need to locate support obligors.

**Discussion 1A:** The JDW stands ready to receive and store case data from all Michigan courts, but some counties opt not to forward their courts' data to the JDW. That leaves the JDW with an incomplete database, which hinders child support enforcement personnel who need information about case files in the nonparticipating courts. According to a survey conducted by the Underground Economy Task Force, a vast majority of Title IV-D personnel

currently access the JDW to obtain information. Having data from *all* Michigan courts would make the JDW even more useful.

The courts that do not participate with the JDW sometimes cite budgetary constraints, but their reluctance usually results from their previous decisions to use private-contract technology vendors instead of the Michigan judiciary's centralized system. Switching from those contractors to the JDW would carry no conversion costs and would be a cost neutral long-term choice for courts and counties. Also, in addition to helping with child support enforcement, having complete state-wide case data in the JDW would help many other state agencies whose effectiveness would improve if they had convenient access to that data.

*Caveat:* Otherwise confidential information about a taxpayer that the IRS has provided to the state or a county must not be transmitted to the JDW.

**Recommendation 1B:** MiCSES and the JDW should have a written data-sharing agreement that allows personnel from the executive branch (OCS/MiCSES) and the judiciary (FOC/JDW) to access each other's data for specific establishment and enforcement purposes outlined in the agreement.

**Discussion 1B:** It often happens that two or more government agencies share the same objective, but do not cooperate fully with each other. At the federal level, the counterproductive rivalries among military services and intelligence agencies are well documented. In Michigan, our child support enforcement program's effectiveness sometimes has suffered from executive and judicial agencies' reluctance to share data. Fortunately, the solution at the state level is clear. Michigan's state agencies may enter into written "data sharing agreements" that spell out exactly when one state agency may access another state agency's data, and the purposes for which the first agency may use the "borrowed" data. Such an agreement between MiCSES and the JDW would significantly enhance MiCSES' effectiveness. As a recommended first step, we suggest allowing the OCS's *executive* staff to access the JDW data, with the possibility of extending that access to include FOC staff after an initial trial period. Long term goals should include importing MiCSES data into the JDW and making all the data accessible and user-friendly for judges and referees.

**Recommendation 1C:** OCS should have access to, and should utilize, the search capabilities of state and municipal retirement systems.

**Discussion 1C:** Hundreds of thousands of active and retired Michigan government employees are members of the State's several state retirement systems and a host of municipal retirement systems. The state-level systems already honor child support orders if

the Office of Retirement Services receives notice of the orders, but the ORS procedures for receiving the orders and withholding child support are not fully automated. They should be.

As for the municipal retirement systems, only serendipitously discovered tax documents allow IV-D workers to learn about financial transfers between those systems and their members. The child support enforcement system would benefit greatly from legislation requiring routine disclosure and enforcement assistance by all municipal retirement systems, including both defined-benefit and defined-contribution plans.

**Recommendation 1D:** All insurance carriers should be required to participate in the Child Support Lien Network.

**Discussion 1D:** Michigan joined the Child Support Lien Network (CSLN) about a year ago, and this allows for an electronic data match between child support obligors and any workers compensation insurance award due to the obligor. This match and intercept process includes comprehensive data exchanges, and allows OCS to file liens against those awards to pay child support arrears. However, participation in the CSLN is voluntary for insurance carriers, so the information OCS receives does not include matches for all carriers. Therefore, the data match is incomplete. This subcommittee recommends that all insurance carriers be required to participate in the CSLN.

**Recommendation 1E:** When a lawsuit against the state results in a child support obligor obtaining a money judgment, OCS and the affected FOC office should have an opportunity to collect any support arrears before the state satisfies the judgment by paying money directly to the support obligor.

**Discussion 1E:** This recommendation virtually explains itself. State money ought not go into the pockets of parents who have failed to meet their court-ordered obligations to pay child support—particularly if the state has provided assistance to the plaintiff’s children to make up for the plaintiff’s previous failure to pay support.

While formulating this recommendation, the subcommittee discussed the recent case in which a group of female prison inmates obtained a \$100 million judgment against the State. Although prisoner lawsuits rarely yield significant monetary judgments, this one did. With prisoner lawsuits, if the Department of Corrections has notice of an outstanding order of restitution against a prisoner, it will divert the judgment proceeds to satisfy the order of restitution before allowing the inmate-plaintiff to receive and retain the money. See MCL 600.5511 and MCL 791.220h. The OCS currently has a plan to intercept prisoner lawsuit proceeds from the female prisoner case. However, a systemic method to capture all prisoner

lawsuit proceeds, and not just the high-profile ones, would benefit the IV-D workers, but more importantly, the children and parents in Michigan who are owed arrears.

As noted above, only rarely does a prisoner obtain a significant monetary judgment against the State. The recent prisoner case mentioned above made headlines, but judgments against the State obtained by plaintiffs who are *not* prisoners present a much bigger problem for child support collection. In these situations, we currently have no established procedures for assuring that judgment proceeds are applied to child support arrears before the State pays money directly to the plaintiff. That currently happens only if IV-D workers somehow learn of the judgment and deliver the child support order and an income withholding order to the Department of Treasury before that department satisfies the judgment.

For internal accounting purposes, Treasury categorizes judgment creditors as “vendors,” a very broad category that includes nearly all of the State’s creditors except State employees (owed wages) and taxpayers (owed refunds). The Enforcement Subcommittee’s report makes several recommendations for intercepting payments to the larger group of “vendors.” Therefore, this recommendation focuses exclusively on judgment creditors.

As already explained, the existing procedures employed by both Treasury and the child support enforcement system do not work well when it comes to intercepting judgment or settlement payments. IV-D workers seldom learn about judgments obtained by child support obligors until it’s too late. And neither FOCs nor OCS routinely provide arrears notices to Treasury—not even when the custodial parent has assigned the arrears debt to the State in return for previous assistance payments. Finally, neither Treasury nor the Office of the Attorney General asks OCS whether a judgment creditor owes back child support.

To collect this support arrears money from successful plaintiffs without requiring significant additional expenditures by government, we recommend new legislation that would create an automated judgment-offset system similar to the very effective tax-offset system that we already have in place. In that existing tax-offset process, Treasury compares its list of persons owed tax refunds with an OCS-provided list of persons who are behind on their child support payments. When Treasury finds a match, it then diverts the tax refund money to the extent required to pay the support arrearage. A similarly structured arrangement should work well for judgment creditors, but we need specific new legislation authorizing Treasury to do that.

One final note: Any new legislation will need to anticipate a complication that is unique to judgment creditors. When the State satisfies a judgment, Treasury often makes the disbursement check payable to the plaintiff’s attorney. Therefore, data-matching a list of

judgment creditors and an OCS list of delinquent support obligors will not trigger an intercept if Treasury's list identifies only the attorney. This problem could be addressed in either the recommended new legislation or an internal Treasury guideline. We mention it here to ensure that it does not become a potential loophole after the other recommended reforms are implemented. Additionally, it is common for settlements to contain non-disclosure clauses or protective orders. Any proposed legislation should anticipate such clauses or orders and ensure that they do not interfere with the ability of multiple state agencies collaborating to collect unpaid child support.

**Recommendation 1F:** MiCSES partners should have access to utility companies' customer data.

**Discussion 1F:** Many child support obligors who reside within Michigan purchase utility services from companies regulated by the state. Cross-matching utility companies' records with child support records would locate many obligors that IV-D workers have not been able to find by other methods. The utilities probably would resist a cross-matching request by citing concerns about both the cost to them and their customers' privacy. Iowa and New Mexico have legislation requiring that utilities provide this enforcement assistance. Those states' child support enforcement agencies have used the laws to overcome utilities' objections and locate many "missing" obligors.

In Michigan, MCL 400.234(1)(e) requires utilities to provide customer information to the Office of Child Support. Other subsections of the same statute allow OCS to obtain many other types of information from virtually any public or private entity. OCS does not currently ask utilities to cross-match their customer records with MiCSES arrears data.

Another statute [MCL 552.518(2)] authorizes FOCs to issue administrative subpoenas to parents' employers, but FOCs' employer-only discovery powers under that statute are very limited compared to those granted to OCS by MCL 400.234. In addition, the disclosure requirements in MCL 400.234 apply only when the information requested by OCS will "[assist] in implementing [the Office of Child Support Act]." MCL 400.234(1). In other words, the existing statutes neither authorize FOCs and prosecutors to request information nor require businesses to disclose to OCS information that would assist in implementing other non-OCS family support laws, e.g., the Friend of the Court Act or the Paternity Act. Therefore, the subcommittee recommends new legislation analogous to, but more inclusive than MCL 400.234.

**Recommendation 1G:** Improve the processes for notifying IV-D workers immediately when a support obligor is incarcerated, or released from incarceration.



**Discussion 1G:** The Prevention Subcommittee has recommended a system for adjusting a convicted person’s child support obligation as soon as a judge sentences that person. Implementing that recommendation would assure that IV-D workers receive prompt notice of incarcerations. But FOCs also need immediate notice when a prisoner is released. The Task Force’s survey of IV-D personnel revealed that many months often pass before they learn of a prisoner’s release. In the meantime, the former prisoner may enter the underground economy before the FOC can reestablish contact.

Creating an interface between MiCSES and the Department of Correction’s “Offender Tracking Information System” (OTIS) would serve that purpose. It also would occasionally allow IV-D workers to identify prisoner-owned assets that could be levied on to pay arrears or current support.

**PRINCIPLE 2:** Expand information sharing between state and federal agencies.

**Recommendation 2A:** The federal Immigration and Customs Enforcement agency (ICE) may share with other law enforcement agencies information that ICE obtains during a criminal investigation. The Attorney General should establish formal collaboration agreements with ICE.

**Discussion 2A:** Employers who hire illegal immigrants also frequently pay their employees in cash. Or, those illegal employees may receive paychecks but enter the underground economy by adopting false identities. ICE initiates an “I-9 investigation” when it learns of a particular company or individual who is suspected of hiring illegal immigrants. The applicable laws allow ICE to share relevant information with Michigan’s Attorney General (a law enforcement official charged with enforcing Michigan’s criminal nonsupport laws), but only if the Attorney General is investigating the same employer.

Because the federal Privacy Act precludes ICE from sharing much information with the Attorney General absent a concurrent ongoing AG investigation, the subcommittee recommends amending the Privacy Act to allow for more information sharing between those two law enforcement agencies in the furtherance of common goals. In addition to ICE’s primary mission, those shared goals should include collecting child support and closing the previously discussed “Tax Gap” at both the federal and state levels.

**Recommendation 2B:** IV-D workers should ask support obligors to sign IRS Form 8821, which will authorize the IRS to provide copies of the obligor’s tax returns and other communications between the IRS and the obligor.

**Discussion 2B:** A signed Form 8821 will allow child support enforcement workers to monitor a support obligor's income or find an obligor who moves without reporting the change of address. But several caveats about Form 8821 are in order. First, only rarely will the IRS have records of income earned in the underground economy. Second, a IV-D worker armed with a signed Form 8821 should phrase a request for documents as specifically and narrowly as feasible. Third, overreliance on Form 8821 could cause an FOC office to receive more documentation than it can process. For those reasons, Form 8821 may prove most useful as a deterrent. An obligor who knows that IV-D workers can get income information from the IRS may think twice before making false statements about income that *might* already be documented in an IRS record.

**Recommendation 2C:** The federal Office of Child Support Enforcement and the Social Security Administration (SSA) should develop a protocol for sharing and disseminating the SSA's annual summary of reported income and projected benefits.

**Discussion 2C:** Everyone who has ever paid Social Security or Medicare taxes receives an annual statement from the SSA that details their lifetime income history year-by-year. This recommendation envisions allowing child support agencies to access that SSA statement or a similar document.

Although neither the IRS nor the SSA will have information about *unreported* income, a look back at a child support obligor's history of *reported* income would help courts and agencies establish support at an appropriate level. Also, analyzing that history and comparing it with evidence of the obligor's current lifestyle could provide clues about current *unreported* income from the underground economy. One of the Task Force's survey questions asked whether the IV-D community would find these SSA income and benefit statements helpful in establishing or enforcing a child support order. Close to 90 percent of the survey participants responded affirmatively.

**Recommendation 2D:** Allow IV-D workers to monitor a support obligor's pending application for Social Security Disability Insurance benefits (SSDI), and then issue an IWO immediately if the Social Security Administration (SSA) does award benefits.

**Discussion 2D:** This is another cross-matching opportunity not currently available to child support enforcement personnel. SSDI applications sometimes remain pending for extended periods, especially if the applicant appeals an initial denial. If the SSA eventually approves a claim, it then makes an initial lump-sum *retroactive* payment of all the monthly benefits that have accrued since six months after the disability began. Thus, the ability to monitor these pending claims would allow child support enforcement agencies to both: (1) levy

immediately on a lump sum retroactive payment of accrued SSDI benefits; and (2) establish a continuing lien on the monthly benefits to be paid in the future.

**PRINCIPLE 3:** Local Friend of the Court offices should think creatively and act on a grassroots level to penetrate the underground economy in their local communities.

**Recommendation 3A:** Hire “field investigators” to assist Title IV-D workers (including FOC referees) by investigating disputed factual issues and performing other investigative work as needed.

**Discussion 3A:** Given their basic job descriptions and heavy caseloads, most support enforcement personnel, especially referees, feel chained to their desks and unable to do investigative work that requires more than quick telephone calls or Internet searches. To borrow a military term, they need “boots on the ground” in the form of investigators who could perform simple investigative tasks (e.g., visit a parent’s home or interview a parent’s employer) to uncover additional facts or reconcile the parties’ conflicting factual contentions, especially regarding income.

Many FOC offices have “investigative units” and, thanks to federal matching funds, a few even have an assigned sheriff’s deputy who performs some investigative work. But these current FOC employees typically do not perform the kind of basic on-the-street detective work that this recommendation envisions. Nor have they been cross-trained in all three of the following areas: support enforcement, police skills, and the underground economy.

The Underground Economy Task Force conducted a comprehensive survey of all Title IV-D personnel. One survey question asked: “Would a field investigator, assigned to assist in the investigation and collection of child support from parents operating in the underground economy, be a useful asset?” Eighty-eight percent of the respondents answered affirmatively. No other survey question elicited a more universally positive response. In addition, task force representatives received similar positive feedback about the field-investigator concept when they gave a presentation about the underground economy to the Michigan Referees’ Association.

Most of the survey respondents believe that the investigators should work out of local FOC offices. To limit the immediate implementation costs and avoid long-term financial commitments, FOC offices could hire the investigators as independent contractors rather than employees. Retired police officers would make ideal candidates for these positions because they already have the required investigative skill set and typically have health insurance provided by their retirement plans.

The only plausible objection to implementing this recommendation is that we lack the funding required to create any additional FOC staff positions at a time when many counties must eliminate personnel because of declining tax revenues. We acknowledge that concern, but offsetting arguments include the availability of federal grants and matching funds, the possibility of shifting current staff to investigative roles, and—above all—our obligation to provide adequate financial support for Michigan children.

Further, even if financial constraints preclude implementing this recommendation immediately, the overwhelmingly affirmative response from the survey respondents shows that this concept has great promise. The Task Force instructed this subcommittee to propose ideas that would increase child support collections from underground economy workers. Field investigators would do that. A possible first step may be to seek federal grant money for a pilot project in a county motivated to take this recommendation to the next level.

**Recommendation 3B:** Create *local* multi-agency and multi-disciplinary Underground Economy teams.

**Discussion 3B:** The people who work in the local offices of prosecuting attorneys, FOCs, DHS, and law enforcement agencies have a wealth of individual and institutional knowledge about the underground economy activities in their communities. For example, a deputy sheriff may know that a certain employer is notorious for paying workers in cash, or that a local payday lending store has an atypical base of frequent customers. But we currently lack systematic approaches for compiling those scattered bits of information so that child support enforcement personnel can use the information effectively.

To begin implementing this local multi-agency concept, we recommend that a workgroup coordinated by the Friend of the Court Bureau design a model for local collaboration. Local IV-D staff then could modify the model to fit their communities' unique circumstances. Within each county, the FOC office should take the lead in forming the local team.

**Recommendation 3C:** Collaborate with local labor unions to discover businesses that either pay their employees in cash or “misclassify” their employees as independent contractors.

**Discussion 3C:** The preceding section recommended forming local teams to detect and report underground economy activity. This section describes a specific opportunity for mutually beneficial collaboration with local entities that have no direct stake in child support enforcement.

As the Prevention Subcommittee explained in the introduction to its report, many workers make a “strategic” decision to enter the underground economy in order to shelter their incomes from both taxation and child support enforcement. Workers that the law considers

“employees” can accomplish that strategic avoidance by getting paid in cash or by acquiescing when an employer misclassifies them as an “independent contractor.” The all-cash arrangement works best for the workers, but intentional misclassification provides an aura of legitimacy while still concealing the income if neither the employer nor the employee reports the payments to the IRS. In another variation on that theme, the supposed independent contractor provides an incorrect Social Security number, the employer files an IRS Form 1099 bearing that false number, and the worker does not report anything.

On the other side of those deals, the employer benefits from not paying employment taxes, insurance premiums, and other miscellaneous employment expenses.

Those illegal employment arrangements frustrate our efforts to collect child support. In addition, their adverse impact on federal and state tax revenues has become so significant that Governor Jennifer M. Granholm issued Executive Order 2008-1 creating the Interagency Task Force on Employee Misclassification. That group’s detailed 2008 and 2009 annual reports can be accessed via their links at <http://www.michigan.gov/dleg/0,1607,7-154-11122-211291--,00.html>.

Intentional misclassification arrangements deprive workers of the protections that our laws afford to all legal employees. They also depress wages. For those reasons, organized labor should be a natural ally for both the tax authorities and the child support enforcement system. See, *e.g.*, this “Labor Voices” OpEd column that appeared in the *Detroit News* on September 30, 2009.

In the previous section’s discussion of forming local teams to investigate the underground economy, we pointed out that many individuals who have no direct connection to the child support enforcement system have jobs that allow them to observe underground economy activities. It’s hard to imagine anyone better positioned to make those observations—and better motivated to report them—than members of a local trade union who see their jobs usurped by underground economy workers.

**Recommendation 3D:** Create a statewide Underground Economy Investigation Protocol.

**Discussion 3D:** One of the survey questions asked IV-D personnel, “Would you find it beneficial to have a quasi-protocol detailing how to deal with parents you suspect are operating in the underground economy?” The vast majority of survey participants endorsed that concept.

The subcommittee envisions that the protocol might include, for example, quantitative case-profile characteristics that enforcement personnel and MiCSES can use to detect cases in which a party may be concealing income. The protocol could also include suggested training

topics, local U.E. investigative procedures, ideas for collaboration with local law enforcement agencies, techniques for identifying support obligors who work in the U.E., and creative intervention mechanisms designed to draw obligors out of the U.E.

SCAO and its Friend of the Court Bureau should convene a workgroup consisting of FOC line staff, prosecuting attorneys, OCS executive staff, FOCs, judges, and referees to draft a state-wide protocol that could be tweaked for local implementation. Special training on the new protocol should follow immediately, and then be included in the FOC annual training.

**Recommendation 3E:** Train police officers on how to obtain usable information from child support obligors who get stopped for traffic violations and then detained when the police discover that the person has a nonsupport bench warrant that requires a court appearance, e.g., for a show cause hearing.

**Discussion 3E:** These are spontaneous encounters. The support obligor will not anticipate questions about the support matter and thus will be more likely to talk about the support case if the officer knows how to guide the conversation. Because the bench warrant emanates from a civil case, the officer will not have to chill the conversational atmosphere by reciting *Miranda* advice before asking questions.

FOC personnel have informed the subcommittee that, for several valid reasons, many police officers hesitate to involve themselves in domestic relations disputes. But if we can enlist and inform them, law enforcement personnel could provide tremendous assistance even without making arrests. For example, suppose that during a traffic stop, the officer's routine check of the LEIN network turns up a bench warrant for failing to pay child support. In the right circumstances, the officer might decide to take the “good cop” approach by giving the motorist documents drafted by IV-D workers which explain the court’s show-cause hearing procedures and the parent’s right to ask the court to amend the child support order.

## **SUMMARY**

Successful collaboration requires creative, outside-the-box thinking. We already have the infrastructure, work force, and creative minds required to implement many of these recommendations. Much can be accomplished if the Title IV-D stakeholders join forces and discuss the realities of the underground economy and its effect on their local communities. The problem is not insurmountable. We can tackle and solve it with a collaborative, grass roots approach.

Respectfully submitted,

Maurice Aouate  
Chair, Collaboration Subcommittee

UNDERGROUND ECONOMY TASK FORCE

APPENDIX C: ENFORCEMENT SUBCOMMITTEE REPORT

March 17, 2010

**SUBCOMMITTEE MEMBERS**

Michael Leibson, Chair  
Suzanne Hollyer  
Richard McLellan  
Doug Roberts  
Dan Bauer (SCAO Staff Support)  
Julie Loveless (SCAO Staff Support)

**MEETINGS**

September 10, 2008  
December 10, 2008  
April 1, 2009  
May 13, 2009  
July 14, 2009  
August 12, 2009  
September 2, 2009  
November 10, 2009  
February 22, 2010

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**INTRODUCTION**

The Task Force has previously received reports from the Prevention Subcommittee and the Collaboration Subcommittee. Like those documents, this report by the Enforcement Subcommittee states several general principles and then elaborates on each principle by offering specific recommendations for increasing tax and child support collections from underground economy entrepreneurs, contractors, and employees.

Compared to the recommendations by the Prevention and Collaboration Subcommittees, our recommendations will seem both more specific and perhaps more difficult to place under one overarching principle. Several factors account for that stylistic difference. First, something inherent in our assignment to explore “enforcement” concepts often caused the subcommittee to begin a discussion by focusing on a very specific technique. Second, several of our recommendations originated as referrals from one of the other two subcommittees.

Finally, this subcommittee concluded that no one will ever discover a single, comprehensive solution to the many problems created by the underground economy. Those problems hit us in a scattergun pattern, so our enforcement efforts must respond in kind. Throughout history, all human societies have had underground economies. The best that we can hope to do is inhibit



underground economic activity. We should try make doing business underground so difficult and costly that anyone who engages in *financially significant* transactions will conclude that it serves their own self-interest to operate legally.

Based on that fundamental enforcement philosophy, the Enforcement Subcommittee now offers the following principles and recommendations for consideration by the Underground Economy Task Force.

## **PRINCIPLES AND RECOMMENDATIONS**

**PRINCIPLE 1:** Child support obligors now working in the underground economy will respond best to external influences and early intervention.

**Recommendation 1A:** Enact a new statute or court rule that confirms and defines judges' authority to issue "pay or stay" orders that include an automatically recurring ultimatum.

**Discussion 1A:** A typical "pay-or-stay" order requires an habitually delinquent support obligor to pay a certain amount each week by Friday afternoon or report to the county jail and stay there until Monday morning. Many judges already issue pay-or-stay orders during show cause hearings. They report that the prospect of spending every weekend in jail often causes obligors to discover previously undisclosed resources that they can use to make child support payments.

Although many judges already use the pay-or-stay enforcement technique, their order language varies. Other judges hesitate to issue pay-or-stay orders because they question their own authority to issue a one-time order that will impose the same recurring ultimatum week after week.

Therefore, the subcommittee recommends new legislation, or a new court rule, that will confirm this judicial enforcement option and specify exactly how judges may exercise it.

In some counties, jail overcrowding or similar budget constraints may cause sheriffs' offices to turn away pay-or-stay prisoners. But the mere threat of incarceration will motivate some support obligors. Where jail is not a viable option, "tethering" may serve almost as well.

**Recommendation 1B:** Courts and FOCs should require divorcing parents to attend pre-judgment educational programs. For never-married parents, similar programs should be offered, but not mandated.

**Discussion 1B:** Few parents fully comprehend courtroom events or the "legalese" in support orders. Because of those foreseeable misunderstandings, some cases go off the rails immediately. This report's Principle 1 emphasizes early intervention and outside controls.

Consistent with that principle, this Recommendation 1B envisions informal planning meetings during which the parents can discuss the proposed child support order with each other and a neutral expert. This will help the parents understand from the outset exactly what the support order requires and promises.

In Michigan, Oakland County has long required divorcing parents to attend pre-judgment educational sessions. The concept's success in divorce cases caused Oakland County to begin imposing the same requirement in paternity establishment cases. However, in the latter category, child support collections did not increase noticeably even when both parents attended.

Oakland County's experience proves that pre-judgment education works well in divorce cases. Unfortunately, it also suggests that the methods used successfully to educate divorcing parents may not work with never-married parents. Nevertheless, the subcommittee believes that counties should at least make this an option for the latter group.

**Recommendation 1C:** Each FOC office should dedicate specific staff resources to closely monitoring cases in which the court either established or significantly modified support within the previous six months.

**Discussion 1C:** Compliance problems in support cases tend to manifest themselves during the first few months after the court enters or modifies a support order. For that reason, FOC offices should track new orders closely so the office can respond immediately when a support obligor misses a payment.

To that end, we recommend that each FOC office maintain a separate new-order docket and assign one or more enforcement workers to that docket. The subcommittee further recommends keeping new-order cases on the special docket for six months, and extending that time by at least three months after a missed payment. FOC offices could modify those recommended parameters according to their local circumstances.

The caseworkers assigned to the special docket should receive specialized training on how to respond immediately to a missed payment.

Because the required close monitoring will require more time per case, any specially assigned workers should have relatively smaller caseloads. Conversely, other personnel in the same office should handle relatively larger caseloads because established, in-compliance cases do not require as much time. Adjusting the caseloads accordingly should increase an office's effectiveness without increasing its personnel costs. The first offices to adopt this recommendation may also qualify for grant funding (e.g., Section 1115 grants) to pilot test this early-intervention concept.

**Recommendation 1D:** Use public scrutiny to locate support obligors and their assets within the underground economy.

**Discussion 1D:** Publicity may succeed where more traditional collection methods have failed with parents who willfully neglect their children’s needs. The popularity of shows like “America’s Most Wanted” demonstrates the public’s willingness to report violations of the law. This recommendation aims to leverage that spirit.

While researching enforcement techniques, the subcommittee learned about many innovative methods of publicizing non-compliance in order to encourage payment. To cite just one example, IV-D workers in Oakland County have increased their collections significantly by mailing “Most Wanted [for failure to pay child support]” posters to obligors’ neighbors and family members. Other possible recipients could include former employers and area churches. The responses will generate leads for locating people who try to avoid their obligations.

This recommendation should only be used in cases where the agency determines that a child will not be harmed by the publicity drawn to the parent’s failure to comply with the child support order.

**Recommendation 1E:** Use an automated system to place calls to delinquent obligors’ cell phones and play recorded messages reminding them to pay their support arrears.

**Discussion 1E:** We recommend starting with a small-scale pilot project to measure this concept’s cost-benefit effectiveness. The Federal Trade Commission’s amended “Telemarketing Sales Rule” that took effect by stages during 2008 and 2009 bans only those automated calls designed to sell goods or services. In its order adopting the amendments, the Commission stated repeatedly that the rule does not apply to “informational” calls. See 73 FR 51164. Therefore, the rule would not prohibit using automated calling to enforce child support orders. We anticipate that this technique would be particularly effective as an early intervention tool.

See also recommendation 4D, below, which calls for data matching with cell phone service providers’ customer lists.

**PRINCIPLE 2:** Our efforts to collect child support and unpaid taxes from underground economy workers must include techniques to accurately identify the relatively few UE workers who earn significant incomes.

**Recommendation 2A:** Use information from the federal government (e.g., passport and customs records) to identify delinquent child support and tax obligors who travel internationally.

**Discussion 2A:** During this project, Underground Economy Task Force members made several presentations at meetings of the Referees Association of Michigan. The referees offered many helpful comments, including their observations that: (1) many delinquent support obligors admit earning money in the underground economy, but (2) probably less than 10% of that group earn more than a subsistence income.

If correct, that 10% estimate should teach us two things. First, with most underground economy workers, identifying them can be only a first step toward enabling them to pay support. Second, to increase collections in the short-term we should focus on identifying the comparatively few underground economy workers who earn good incomes.

In IRS audits, that agency often compares a taxpayer’s “lifestyle” to the person’s reported income. If the reported income could not support the documented lifestyle, that fact constitutes circumstantial evidence that the taxpayer has unreported income.

This recommendation applies the same concept. A parent who travels internationally (at least beyond near-border communities) obviously has sufficient income or assets to pay child support and taxes. Indeed, the mere fact that someone has paid to obtain a passport should warrant skepticism if the person claims to be unable to pay *any* support.

Note that this recommendation goes beyond current law and practices that allow the authorities to intercept and confiscate passports. This recommendation focuses on identifying support obligors who have significant assets, as evidenced by their international travel.

**Recommendation 2B:** Collections staff should receive specialized training on IRS techniques for investigating the underground economy.

**Discussion 2B:** The IRS’s Criminal Investigation Division has occasionally provided this type of instruction (“Financial Investigative Techniques”) to Michigan law enforcement agencies. We recommend arranging similar training for our Title IV-D personnel. A one-time live presentation could be recorded and archived for repeated use.

**Recommendation 2C:** Assign selected Title IV-D or Department of Treasury personnel to investigate local underground economy activity.

**Discussion 2C:** This goes hand-in-hand with the preceding recommendation. Each day, most of us encounter some underground economy activity. Not all lawn-service workers, ticket scalpers, and souvenir vendors routinely report their cash incomes. But we usually don’t even pause to realize that we have witnessed underground economy transactions, let alone consider reporting them. After all, reporting is “not our job” and citizens don’t have a standard procedure for making such reports. Proper training of IV-D and Treasury personnel will

heighten their awareness, and investigative assignments for designated personnel will make reporting their duty.

It's not realistic to expect citizens to report every street-corner T-shirt vendor, but neither should we view citizen involvement as a lost cause. The underground economy enables tax evasion and requires governments to support children who should receive financial support from their parents. Many, perhaps most, people believe that taxes are too high and that governments waste tax money. Those people should feel outraged when they see scofflaws avoiding taxation while the scofflaws' children—and sometimes even the parents—receive tax-funded assistance. A public education campaign that clearly connected those dots would generate citizen reports of underground economy activity. To convert people's instinctive anger into proactive involvement, we will need an easy-to-use (and preferably anonymous) reporting mechanism and then some highly visible enforcement actions based on citizen reports.

**Recommendation 2D:** Ask local contacts to help identify underground economy workers.

**Discussion 2D:** Title IV-D personnel routinely refer parents to local therapists and other local service providers. Similarly, local law enforcement agencies routinely enforce nonsupport bench warrants. IV-D personnel do not have the time for extensive detective work, but they do have that established network of local contacts who are constantly out in the community, observing and listening. Those people could serve as additional eyes and ears for office-bound IV-D personnel. As with the public outreach discussed in the preceding section, activating this resource would require educating people about the underground economy and making specific requests for assistance.

**Recommendation 2E:** Reach out to potential allies who are harmed by the underground economy in ways not directly related to either taxation or child support.

**Discussion 2E:** Every community includes many potential allies who have no official connection to the child support enforcement system. Here are just three examples. First, business people who operate within the law must compete with underground businesses that enjoy at least a 20 percent cost advantage. Second, the underground economy causes workers, especially union workers, to lose jobs or accept lower wages. Third, police officers often observe illegal activities that, in isolation, are too insignificant to warrant criminal prosecution.

All of those groups have legitimate motives to help us ferret out underground economy activity. But unless we reach out to them, we can't expect them to realize that reporting underground economy activity to Title IV-D personnel or the Department of Treasury will further their own interests.

**Recommendation 2F:** Enact clear statutory authority (notwithstanding any other law to the contrary) for Title IV-D personnel and tax collection agencies to obtain wages-paid information from any public or private entity if the information will aid in the enforcement of a tax or child support obligation.

**Discussion 2F:** See **Discussion 1F** in Collaboration Subcommittee Report on page B-5.

**PRINCIPLE 3:** Strengthen other existing statutes, court rules, and professional ethical codes to allow better enforcement of our tax and child support laws.

**Recommendation 3A:** Enact legislation requiring state-licensed casinos to check a child support arrearage data base before paying jackpot winners. When a casino finds a match, it should pay its customer only the difference (if any) between the jackpot win and the support arrears debt. The remaining money should be remitted to the appropriate Title IV-D entity.

**Discussion 3A:** Pending 2009 SB 68 would do exactly that. Its sponsor modeled the bill on a successful Colorado law; however, to reduce the administrative burden for Michigan casinos, we recommend raising the bill's jackpot threshold from \$1,000 to \$1,200, which is the existing threshold for casinos' obligation to issue an IRS Form W-2G. Also, allowing casinos to collect an administrative fee in return for their enforcement assistance should reduce opposition to the bill.

The Senate bill includes an acknowledgement that current federal law precludes Michigan from requiring Native American casinos to provide support-enforcement assistance. That creates a significant obstacle to the bill's passage. Colorado has only two tribal casinos, both located in that state's remote southwestern corner. Unlike Colorado, Michigan has several Native American casinos (and one Canadian provincial casino) located within easy driving distance of our three state-licensed casinos. Therefore, enacting the bill would place the state-licensed casinos at a competitive disadvantage. The best solution would be to enact a federal requirement that applied to tribal casinos in the same manner as the IRS reporting requirement. In the absence of a new federal law, the bill instructs the chairperson on the Michigan Gaming Control Board to seek voluntary state-tribal cooperation agreements.

**Recommendation 3B:** Allow the Michigan State Disbursement Unit (MiSDU) and the Michigan Child Support Enforcement [computer] System (MiCSES) to hold and administer lump-sum surety bonds guaranteeing the payment of future support by obligors who have significant current assets, but doubtful prospects for earning future income.

**Discussion 3B:** In a sad but too-common scenario, a support obligor suffers a permanently disabling injury and wins a money damages judgment or receives a lump-sum worker's

compensation award. In the past, FOCs would petition the court to require the obligor to post a surety bond covering the anticipated future child support obligation. If the obligor paid directly, the FOC would release a pro rata portion of the bond. On the other hand, if the obligor missed an installment, the FOC would draw the appropriate amount from the bond and pay that money to the custodial parent. That procedure worked well.

Unfortunately, that procedure became unworkable when MiSDU and MiCSES entered the picture. By law, MiSDU may not collect *future* support payments, and OCS believes that the same restriction precludes using MiCSES to administer this type of surety bond. As a result, FOCs have ceased using what had been an effective collection technique.

But the underlying problem has not gone away. Obligor who lack the ability to earn a regular future income too often deplete a lump-sum financial award before their obligation to pay child support ends.

For those reasons, the subcommittee recommends enacting state legislation empowering a centrally administered authority to receive and administer this special type of surety bond.

**Recommendation 3C:** Coordinate all state government license-issuing agency websites and data bases so that a single online search can discover all State of Michigan licenses held by a support obligor.

**Discussion 3C:** Presently, anyone who needs to determine another person's licensed status (e.g., professional, recreational, or operator's) must figuratively go door-to-door, inquiring separately at each of the state agencies that issue licenses. This makes it difficult for Title IV-D and Treasury Department personnel to optimize their license-suspension authority. It also enables people to fraudulently obtain new issues of some types of licenses even after an original license has been suspended or revoked.

To address those problems, the subcommittee recommends creating a state-operated Internet search engine that will allow a single inquiry to locate all state licenses held by a child-support or tax obligor. This database should interface with MiCSES.

**Recommendation 3D:** Use special colored-coded paper for certain enforcement documents to ensure that people read the forms.

**Discussion 3D:** Guernsey County in east-central Ohio reported in a national child support peer newsletter that it increased its percentage of appropriate responses to license-suspension warnings when it began printing the notices on bright-pink paper. At this subcommittee's request, Bay County (Michigan) agreed to try the same procedure. Bay County's early results have not approached the Ohio county's success rate, but the experiment will continue. The



subcommittee also discussed printing driver’s license photos in the warning notices to enhance the notices’ impact.

**Recommendation 3E:** Enact federal legislation that unequivocally authorizes Title IV-D agencies and the Michigan Department of Treasury to use consumer credit reports for enforcement purposes.

**Discussion 3E:** Title IV-D personnel may obtain parents’ credit reports and use that information to establish the appropriate child support amount. Before 2003, they also routinely used credit reports to enforce support orders.<sup>29</sup> But the Fair and Accurate Credit Transactions Act of 2003 (FACTA) modified 15 U.S.C. §1681b, and has caused at least two federal courts elsewhere to question that practice.<sup>30</sup> In Michigan and the federal Sixth Circuit, there is no recent judicial precedent approving this use of credit reports, so the conflicting dictum by other federal courts has inhibited Michigan’s use of this enforcement mechanism, but does not provide binding guidance. To clarify the situation, we recommend that Congress amend the federal statute again to unequivocally grant IV-D personnel the authority to use credit reports for support enforcement.

**Recommendation 3F:** Amend the notice requirement in Michigan’s felony nonsupport law (MCL 750.165) to allow a felony prosecution even if the support obligor was not personally served in the underlying civil case that established the support obligation.

**Discussion 3F:** Currently, prosecutors may charge nonsupport as a felony only if “...the individual ordered to pay support appeared in, or received notice by personal service of, the action in which the support order was issued.” MCL 750.165(2). That language prevents a felony prosecution when, in the underlying civil case, the support obligor evaded attempts at personal service and failed to appear. Michigan’s Office of the Attorney General asked the Task Force to consider recommending an amendment of MCL 750.165 that would ease the personal-service requirement. This subcommittee concluded that substituting the following language for current MCL 750.165(2) would address the OAG’s concerns while also protecting defendants’ due process rights.

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<sup>29</sup> See *Hasbun v. County of Los Angeles*, 323 F3d 801 (CA 9, 2003).

<sup>30</sup> See *Pintos v. Pacific Creditors Ass'n*, 504 F3d 792, 799 n3 (CA 9, 2007)[*Pintos I*], withdrawn by 565 F3d 1106, 1110, 1113 (CA 9, 2009)[*Pintos II*], and *Miller v Trans Union LLC*, [unpublished] 2007 US Dist LEXIS 14315 (ND IL, 2007). As indicated by the citations, the Ninth Circuit withdrew the problematic dictum in its first *Pintos* decision, and also acknowledged its earlier *Hasbun* decision. But *Miller* includes reasoning similar to that in *Pintos I*, and the current federal statute does lend itself to differing interpretations

“This section [making nonsupport a felony] does not apply unless, in the civil action in which the support order was issued, the individual appeared or was served with process in accordance with MCR 2.105(A)(1) or (2). For the purposes of this subsection, an appearance in the civil action includes, without limitation, actually appearing before the court or making any voluntary or involuntary payment required by the support order.”

By referencing MCR 2.105(A)(2), that language would allow a felony nonsupport prosecution if the summons and complaint in the underlying civil case were served by registered or certified mail. Similarly, the special definition of “appeared” would allow a felony nonsupport prosecution when—regardless of whether personal service was accomplished in the civil case—the defendant’s support payment history demonstrates actual knowledge of the civil case and the support order.

**NOTE:** This recommendation and the next one do not specifically target the underground economy, but the subcommittee opted to include them, for several reasons. First, many felony nonsupport cases involve defendants who are involved in the underground economy. Second, personnel from the Office of the Attorney General provided substantial assistance to the Task Force, and they requested this addition. Finally, we hope that the Task Force’s final report will raise the profile of these recommendations and lead to the passage of amending legislation.

**Recommendation 3G:** Harmonize the Michigan felony nonsupport statute (MCL 750.165), and the Michigan restitution statute (MCL 780.766) to clarify two points. First, a defendant convicted of felony nonsupport case must pay restitution that includes the support arrears owed on the underlying civil judgment. Second, a restitution order in a felony nonsupport case does not affect the underlying support order or the authority of FOCs and OCS to enforce the support order.

**Discussion 3G:** The Crime Victim’s Rights Act requires that a sentencing court order the defendant to pay full restitution to the crime victim (or to any entity that has previously compensated the crime victim for the same loss). MCL 780.766(2) and (8). In felony nonsupport cases, restitution should include paying support arrears to the noncustodial parent (or to the State if it has provided government benefits to compensate for the defendant’s failure to pay support).

Some FOC offices mistakenly believe that a restitution order in a felony nonsupport case supersedes the earlier child support order in the underlying civil case. Those FOC offices remove the support order from MiCSES and stop enforcing the support order. That should not happen. To the contrary, a restitution order should *reinforce* the support order and provide FOCs with an *additional* enforcement tool.

To clarify this matter, the subcommittee recommends adding the following new subsection to the felony nonsupport statute.

“As part of the restitution required by MCL 780.766, the court shall order a defendant convicted under this section to pay all support required by the existing support order and any consequential damages resulting from the defendant’s previous failure to pay support. To the extent that the restitution order reiterates the support order, the friend of the court shall continue to enforce that obligation, and the defendant shall make the payments to the state disbursement unit.”

**Recommendation 3H:** In felony prosecutions involving a seizure of assets that are subject to forfeiture if the defendant is convicted, prosecutors and other Title IV-D personnel should collaborate to determine whether the defendant owes child support arrears. If so, the FOC should prepare to levy on the assets immediately if the criminal prosecution does not result in a conviction and forfeiture.

**Discussion 3H:** MCL 750.159j(4) authorizes courts to order the forfeiture of assets that were used to further a criminal enterprise, or that represent the proceeds of that criminal enterprise.

The federal Racketeer Influenced and Corrupt Organizations act (RICO, 18 USC 1961 et seq.) includes a similar provision in 18 USC 1963. Other federal and Michigan laws authorize asset forfeitures after convictions for certain drug crimes.

But courts may order a forfeiture of assets only if the owner is convicted of a specified offense. See, e.g., MCL 750.159i. If the defendant is acquitted, the defendant may reclaim the assets from the law enforcement agency that seized them.

This recommendation envisions a scenario in which an acquitted defendant owes child support arrears. After a not guilty verdict, the seizing law enforcement agency will have no continuing claim to the assets, but the child support enforcement system may impose a lien on them. In that scenario, the FOC office will need to perfect the child support lien before the acquitted defendant regains possession of the assets. That will require close collaboration between the FOC, the prosecutor, and the law enforcement agency that seized the assets.

**Recommendation 3I:** Modify the forfeiture laws to allocate some forfeiture proceeds to pay past-due taxes and child support.

**Discussion 3I:** Post-conviction in a criminal-enterprise forfeiture case, the law enforcement agency that seized the assets retains them until they can be sold. See, e.g., MCL 750.159j(9). The selling unit of government then may retain whatever sale proceeds remain after it satisfies certain higher priority claims to the assets. MCL 750.159r. Those higher priority liens include

“any valid outstanding lien against the property that has been imposed by [another] governmental unit.” MCL 750.159r(1)(d). The remaining money “shall be used to enhance enforcement of the criminal laws.” MCL 750.159r(1)(f).

This subcommittee believes that if the convicted person owes back taxes or child support arrears, the taxing unit’s claim for the unpaid taxes, or an FOC’s claim for the support arrears, should qualify as a governmental-unit lien against the forfeited assets. The existing forfeiture statutes can be read that way, but the subcommittee anticipates that interagency competition for the forfeiture proceeds will make it necessary to amend the statutes to specifically dedicate part of the money to pay child support arrears.

As noted above, MCL 750.159r(1)(f) states that forfeiture proceeds “shall be used to enhance enforcement of the criminal laws.” A failure to pay taxes or child support may constitute either a civil or criminal offense. Nonpayment while possessing significant assets tilts toward the criminal end of that spectrum. Furthermore, using forfeiture proceeds to provide court-ordered support for children and custodial parents serves to “enhance the enforcement of the criminal laws” by enforcing court orders and ameliorating poverty that might otherwise cause children or custodial parents to commit crimes out of economic necessity. To cite just one easy example, forfeiture money could fund the “booting” of obligors’ cars. See Recommendation 4A.

**Recommendation 3J:** Fix data-matching problems with quarterly wage reports and resume the automatic issuance of Income Withholding Notices based on matched data.

**Discussion 3J:** The Michigan Employment Security Act requires employers to file quarterly reports of the wages they pay to employees for “covered” employment (i.e., employment subject to Michigan’s unemployment tax). See MCL 421.13(2). Michigan’s child support program has access to the data compiled from those reports. If an obligor is reported as employed and earning wages, MiCSES should note that fact and automatically send an Income Withholding Notice (IWN) to the employer.

In the past, Michigan did use the quarterly wage data for cross-matching and automatic IWN issuance. That practice stopped at a time when the data in the quarterly wage file caused duplicate IWNs to issue to the same employer for the same NCP. The subcommittee recommends resolving any issues related to using this data source to match NCPs with employers and then reinstating automatic IWN generation.

**Recommendation 3K:** Provide guidance to jurists (judges and family-court referees) regarding whether they must report information about a person’s underground economy income when the jurist has obtained that information while conducting a hearing to establish or modify child support.

**Discussion 3K:** Underground Economy Task Force representatives attended several meetings of the Michigan Association of Referees to brief the referees and seek their input. The referees are familiar with the underground economy because parents often admit that they earn unreported income while testifying during hearings or just conversing with referees.

Those admissions help jurists (referees and judges) establish appropriate levels of child support. But the jurists then find themselves in an ethically awkward position. They know that the parent or employer has violated the tax laws by failing to report income, but if jurists were to begin reporting that information to the tax authorities, parents will stop admitting it. That would deny jurists the income data that they need to calculate the correct child support amount. *Not* reporting the tax law violations is a win/lose proposition because children receive needed financial support, but the state and federal governments lose an opportunity to collect additional tax revenue. On the other hand, relaying the information to the taxing authorities would soon create a lose/lose situation in which children would go without the additional support, and the tax authorities would never learn about the unreported income anyway.

At present, the referees almost always use the parents' admissions to right-size the child support order, but do not report what they have learned to the tax authorities. They feel uncomfortable choosing that (or any other) course of action and wish that some higher authority would provide clear ethical guidance.

This subcommittee understands the jurists' ambivalence and discomfort. Absent authoritative guidance, we recommend that jurists respond by simply ordering parents to report the previously unreported income.

Basically the same approach would work with parents who claim large child-care payments to relatives or friends. Before allowing those expenses, jurists can insist on proof that the recipient properly reported the income.

**PRINCIPLE 4:** New special-purpose statutes targeting the underground economy will provide effective new enforcement tools. [NOTE: The phrasing of the following recommendations assumes the passage of appropriate enabling legislation.]

**Recommendation 4A:** "Boot" cars owned by parents who owe child support arrears.

**Discussion 4A:** Anyone who can afford to buy, register, insure, maintain, and fuel an automobile also has the ability to pay some child support. Temporarily immobilizing the car will at least force the parent to meet with FOC personnel and explain the paradox. Late in 2009, the Michigan Legislature amended the Support and Parenting Time Enforcement Act by adding authority for courts to order law enforcement agencies to boot an obligor's car if the

obligor fails to appear for a contempt show cause hearing. See MCL 552.631(1)(g). The subcommittee recommends authorizing this enforcement technique in additional circumstances. Also, because booting requires expenditures for both equipment and police officers' time, the courts and IV-D agencies will need a source of revenue to fund this new enforcement option.

**Recommendation 4B:** Confiscate season tickets to sporting events, resell the tickets, and use the proceeds to pay support arrears and delinquent taxes

**Discussion 4B:** Data matching will identify parents who have enough money to buy season tickets, but not enough to pay court-ordered child support. The overlap probably is small, but we should not tolerate any overlap.

**Recommendation 4C:** Data match with cell phone providers' subscriber lists.

See also Recommendation 1E (automated reminder calls) and Recommendation 2F (new legislation increasing FOCs' discovery powers).

**Discussion 4C:** It seems that "everyone" has a cell phone. Those who do obviously have the financial ability to pay for the service and ought to have the ability to pay some child support.

We recognize that support obligors could frustrate this particular detection technique by purchasing disposable phones and prepaid calling plans. However, every such avoidance maneuver costs money and convenience. We should strive to make avoidance so expensive and inconvenient that paying taxes or child support will seem preferable.

**Recommendation 4D:** Cross-check support obligors' federal, state, and (if applicable) local income tax returns. Also examine local property tax records. Investigate any inconsistencies.

**Discussion 4D:** Some taxpayers file only some of their required income tax returns. Others file all the returns but report varying income amounts. The discrepancies often involve attempts at tax evasion or income concealment. For example, "tax protestors" are especially prone to reporting inconsistent income data. There is considerable overlap between the underground economy and the alternative universe inhabited by tax protestors. Statutory authorization and established procedures for comparing a child support obligor's federal/state/municipal/property tax returns would enable Treasury Department and Title IV-D personnel to discover discrepancies and inquire about them.

**Recommendation 4E:** Anyone selling merchandise at a location other than a permanent store must obtain and prominently display a license showing that the business has been registered with an appropriate governmental unit.

**Discussion 4E:** The core idea here is that a *failure* to display a license would provide cause to investigate. Conversely, obtaining and displaying documentation such as a sales tax license or a township permit would effectively inoculate a vendor against groundless inquiries.

Properly written and administered, such a law should make compliance easy because the goals are to keep the retail activity aboveground and create verifiable records. The law should not inhibit family garage sales. It should, however, unequivocally authorize official inquiries about income flows at flea markets and among ticket resellers.

See, for example, the Hawai`i Cash Economy Enforcement Act of 2009, HRS 231-91 et seq., which imposes new recordkeeping requirements on “cash-based businesses” and allows a newly created “Special Enforcement Section” to inspect a business’s premises and records without advance notice. According to media reports, proponents expect the new law to increase that state’s general excise tax collections by \$100 million over the first three years.

Opponents predict that the law will prove to be both overly burdensome and ultimately unworkable. At this point in time, the subcommittee does not recommend that Michigan enact similar legislation. But we should monitor the subsequent developments in Hawai`i.

**PRINCIPLE 5:** Employers should be discouraged from enabling the underground economy.

**Recommendation 5A:** Confiscate and revoke the business licenses of employers who pay their employees in cash and do not report the payments *properly* on tax forms filed with the federal, state, and local tax agencies.

**Discussion 5A:** A developer needs a builder’s license to build and sell houses. A trucking business will struggle without common carrier and vehicle licenses. Few bars can operate profitably without a liquor license. Those are three prominent examples of businesses that notoriously pay workers in cash or misclassify their employees as independent contractors. For more details and some informed estimates of the resulting underpayments of Michigan taxes, see the 2009 report by the Interagency Task Force on Employee Misclassification, accessible via this link: <http://www.michigan.gov/dleg/0,1607,7-154-11122-211291--,00.html>.

This recommendation and the next one are designed to exact such a high price for misclassifying workers or not reporting wage payments that employers will find it cheaper to obey the laws.

Obviously, these recommendations assume that governments will administratively enforce the laws. In the absence of adequate funding for enforcement efforts and a genuine will to enforce, no recommendation by a task force can save the day.



**Recommendation 5B:** Require employers who intentionally misclassify their workers, or who make unreported cash wage payments to assume the workers’ obligations for the resulting underpayments of taxes and child support. That new obligation would be in addition to the employers’ own original obligation to pay taxes, insurance premiums, and other costs of doing business legally. To encourage violation reports, the new law should include whistleblower protections for employees who report their employers.

**Discussion 5B:** As documented in the 2009 annual report of Michigan’s Interagency Task Force on Employee Misclassification, employers avoid significant tax and insurance expenses by failing to report employee compensation or misclassifying the payments that they do report. (See link in section 5A, above.) That gives lawbreakers a big competitive advantage over employers who play by the rules. It also allows the lawbreakers’ employees to evade their own tax and child support obligations. Further, as the Misclassification Task Force also has documented, employers who choose to operate that way believe that the risk of detection is so slight that the rewards outweigh that risk. This subcommittee Recommendation 5B would increase employers’ “detection risk” in two ways.

First, it will increase the probability of detection because requiring lawbreaking employers to pay workers’ child support arrears and back taxes will incentivize everyone to report employers. Custodial parents and IV-D personnel already have some incentives, but identifying a deep-pocketed source of arrears payments will increase those incentives. Further, this recommendation will enlist noncustodial parents in the detection effort by holding out the prospect that the courts will require a former employer to pay their support arrears.

Second, having to pay a worker’s child support arrears and back taxes will increase the absolute dollar cost for those employers who do get caught. By thus altering employers’ risk-reward calculus, this recommendation will increase tax and child support collections from two employer groups: (1) those who get caught; and (2) those who revisit their risk analysis and decide that the rewards of cheating no longer outweigh the risks.

Respectfully submitted,

Enforcement Subcommittee

# **Unreported, Underreported, and Disguised Income**

**How Much is Your Obligor Drawing from the Underground Economy?**

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**For Minnesota Family Support & Recovery Council**

**Tuesday September 30, 2014**

**Saint Cloud, MN**

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# I. INTRODUCTION

By definition, unreported and hidden income is produced by the underground economy. The Internal Revenue Service estimated \$376 billion of the 2006 tax gap stems from underreported income. Hidden and underreported income is not found in financial statements or tax returns. However, it usually can be found somewhere in the books and records of a business. After all, while they may wish to conceal the income from a regulatory authority, the income earner usually needs to keep track of finances for their own ends.

## The Players

Income from self-employment and rents reports differently than wage income. Unlike wages, which are reported by an employer, the income of a self-employed person is reported at their discretion. This discretion can take the form of blatant non-reporting or underreporting of income.

Unreported income involves individuals off the radar; unreported income is far more underground than hidden income. It is not unusual to find general and specialized service businesses operating in the underground. This could be a service that requires licensing yet is not licensed. Examples would be a non-licensed car dealer or a business such as lawn maintenance and snow plowing that isn't registered for sales tax. These businesses are not registered with the Secretary of State; all assets are in the individual's names.

Generally, these individuals do not keep business records and do not file individual income tax returns or report their true income on those returns. These individuals likely acquire a business from word of mouth and Craigslist and can undercut their legitimate competitors' prices. They maintain a relatively low key and simple lifestyle, own older homes and vehicles but usually have little or no debt relative to their assets.

Hidden or underreported income involves individuals far less off the radar than unreported income. For example, the owner or officer has a legitimate business. The business may be registered with the Secretary of State, have a Federal Employer Identification Number (FEIN), and current professional licensing, if applicable. Often, the business is registered as an LLC or S-Corporation; this means, for tax purposes, the income is passed from the business to the individual. However, the business may be structured as a closely held C-Corporation or as a sole proprietorship. Assets may be financed and documented with a UCC at the Secretary of State, and there are usually one or more bank accounts in the business' name.

Net income can be underreported using incorrect reporting of income or incorrect reporting of expenses – or both.

**Gross sales/receipts**  
**Less: Business expenses**  
**Equals: Net profit**

Business income or gross receipts could be incorrect due to the owner skimming cash. Additionally, expenses could be personal in nature or fictitious. Common owner/officer compensation issues include not reporting wage income (W2), very low reported wage income not competitive with the service provided, paying personal expenses with the

business accounts, fringe benefits, taking cash out of the business without properly recording the transaction, or taking cash as a loan without proper loan documentation.

## The Bottom Line

Income determination is both a science and an art. While verifying expenses is relatively easy, determining income requires a deliberate methodology.

## II. The Statute

### 518A.30 INCOME FROM SELF-EMPLOYMENT OR OPERATION OF A BUSINESS

For purposes of section 518A.29, income from self-employment or operation of a business, including joint ownership of a partnership or closely held corporation, is defined as **gross receipts minus costs of goods sold minus ordinary and necessary expenses** required for self-employment or business operation. Specifically excluded from ordinary and necessary expenses are amounts allowable by the Internal Revenue Service for the accelerated component of depreciation expenses, investment tax credits, or any other business expenses determined by the court to be inappropriate or excessive for determining gross income for purposes of calculating child support. The person seeking to deduct an expense, including depreciation, has the burden of proving, if challenged, that the expense is ordinary and necessary

From the above statute, income is calculated as follows:

- Gross Receipts (GR)**
  - **Cost of Goods Sold (COGS)**
  - **Ordinary and Necessary Expenses**
- Income from Self-Employment**

The calculation for income can be subject to error from incorrectly reported gross receipts (sales) or expenses – or both! Income determination can be approached by reconstructing gross receipts or verifying expenses. It is almost always easier and faster to tackle the expenses first; as sales reconstruction can be time consuming.

## III. Tackling the Expenses

### Ordinary and Necessary Business Expenses

To be deductible, a business expense must be both ordinary and necessary. Unfortunately, the IRS does not define “ordinary” or “necessary”. A commonly used definition: “an ordinary expense is one that is common and accepted in the trade or business”. A necessary expense is one that is helpful and appropriate for the trade or business. An expense does

not need to be absolutely essential to be considered necessary. What is ordinary and necessary in one industry may not be ordinary and necessary in another.

A business cannot deduct personal, living or family expenses. The IRS does allow business use of the home and a proportional amount of home expenses; but these expenses often fall under scrutiny. Businesses that report 100% business use of a non-commercial vehicle are also suspect.

It is important to separate business expenses from the following expenses:

- The expenses used to figure the cost of goods sold (COGS),
- Capital Expenses, and
- Personal Expenses.

From the Federal Schedule C, ordinary and necessary business expenses include categories such as advertising, supplies, repairs, interest, and more. The business' burden to keep proper records and substantiate expenses can be found in IRS Publication 17, IRS Publication 535, and IRS Publication 463. Expenses for travel, meals and entertainments, and gifts are often abused; the IRS has strict substantiation requirements for record keeping.

## Schedule C Expenses, Page 1

Part II Expenses		Enter expenses for business use of your home only on line 30.					
8	Advertising . . . . .	8		18	Office expense (see instructions)	18	
9	Car and truck expenses (see instructions) . . . . .	9		19	Pension and profit-sharing plans . . . . .	19	
10	Commissions and fees . . . . .	10		20	Rent or lease (see instructions):		
11	Contract labor (see instructions)	11		a	Vehicles, machinery, and equipment	20a	
12	Depletion . . . . .	12		b	Other business property . . . . .	20b	
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions) . . . . .	13		21	Repairs and maintenance . . . . .	21	
14	Employee benefit programs (other than on line 19) . . . . .	14		22	Supplies (not included in Part III) . . . . .	22	
15	Insurance (other than health)	15		23	Taxes and licenses . . . . .	23	
16	Interest:			24	Travel, meals, and entertainment:		
a	Mortgage (paid to banks, etc.)	16a		a	Travel . . . . .	24a	
b	Other . . . . .	16b		b	Deductible meals and entertainment (see instructions) . . . . .	24b	
17	Legal and professional services	17		25	Utilities . . . . .	25	
				26	Wages (less employment credits) . . . . .	26	
				27a	Other expenses (from line 48) . . . . .	27a	
				b	Reserved for future use . . . . .	27b	

## Schedule C Expenses, Page 2

**Part V Other Expenses.** List below business expenses not included on lines 8-26 or line 30.

Should I deduct the same expenses on page 1 here too? Then I can take these same expenses twice!		
48 Total other expenses. Enter here and on line 27a	48	

Schedule C (Form 1040) 2013

## IRS Pub 535 Record Keeping Requirements

IF you have expenses for . . .	THEN you must keep records that show details of the following elements . . .			
	Amount	Time	Place or Description	Business Purpose Business Relationship
<b>Travel</b>	Cost of each separate expense for travel, lodging, and meals. Incidental expenses may be totaled in reasonable categories such as taxis, fees and tips, etc.	Dates you left and returned for each trip and number of days spent on business.	Destination or area of your travel (name of city, town, or other designation).	<u>Purpose:</u> Business purpose for the expense or the business benefit gained or expected to be gained. <u>Relationship:</u> N/A
<b>Entertainment</b>	Cost of each separate expense. Incidental expenses such as taxis, telephones, etc., may be totaled on a daily basis.	Date of entertainment. (Also see <i>Business Purpose</i> .)	Name and address or location of place of entertainment. Type of entertainment if not otherwise apparent. (Also see <i>Business Purpose</i> .)	<u>Purpose:</u> Business purpose for the expense or the business benefit gained or expected to be gained. For entertainment, the nature of the business discussion or activity. If the entertainment was directly before or after a business discussion: the date, place, nature, and duration of the business discussion, and the identities of the persons who took part in both the business discussion and the entertainment activity. <u>Relationship:</u> Occupations or other information (such as names, titles, or other designations) about the recipients that shows their business relationship to you. For entertainment, you must also prove that you or your employee was present if the entertainment was a business meal.
<b>Gifts</b>	Cost of the gift.	Date of the gift.	Description of the gift.	
<b>Transportation</b>	Cost of each separate expense. For car expenses, the cost of the car and any improvements, the date you started using it for business, the mileage for each business use, and the total miles for the year.	Date of the expense. For car expenses, the date of the use of the car.	Your business destination.	<u>Purpose:</u> Business purpose for the expense. <u>Relationship:</u> N/A



## Business Expense Records

Businesses are held to a higher standard of record keeping than an individual. It is not out of line to request: complete accounting books and records including the general ledger and other journals, all business bank and credit card statements, and sales and purchases invoices and receipts.

BizStats is an online resource that provides business financial ratios for industries. This site is helpful for demonstrating ordinary and necessary business expenses for industries, as well as industry standards for categories of expenses compared to gross receipts.

## Vehicle Expenses

The expenses for business use of vehicles are allowable and reported on the first page of Federal Schedule C. A business may elect to expense a vehicle with either the standard mileage rate or actual expenses – not both!

Actual expenses include gas, oil, repairs, tires, insurance, licenses and depreciation. Using the standard mileage rate, the actual expenses are estimated in the rate so the actual expenses are not allowed in addition to the standard mileage calculation. The calculation for vehicle expense is found on page 2 of Federal Schedule C part IV.

## Schedule C page 2 part IV

Part IV **Information on Your Vehicle.** Complete this part **only** if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 1.3 to find out if you must file Form 4562.

43 When did you place your vehicle in service for business purposes? (month, day, year)  /  /

44 Of the total number of miles you drove your vehicle during 2013, enter the number of miles you used your vehicle for:

a Business  b Commuting (see instructions)  c Other

45 Was your vehicle available for personal use during off-duty hours?  Yes  No

46 Do you (or your spouse) have another vehicle available for personal use?  Yes  No

47a Do you have evidence to support your deduction?  Yes  No

b If "Yes," is the evidence written?  Yes  No

## Officer Compensation Issues

Essentially, officer compensation issues are mischaracterized expenses. Generally, shareholders of S-corporations are officers of the corporations and thus are employees under Internal Revenue Code §3121(d)(1). The owners/officers often try to avoid FICA and FUTA taxes by taking payments they do not classify as wages or are reporting minimal payments as wages. Another reason for not classifying payments as wages is to avoid filing employment tax returns. Many S-corporations are operated by only the sole owner. The business may consider it a burden to file employment tax returns for only one employee.

Many business owners use the corporate bank account to write checks for personal expenses such as mortgage payments, credit cards payments, car payments, gym memberships, etc. The personal payments may be recorded as distributions or loans but are often recorded as expenses deducted by the corporation. These expenses are found during

a bank deposit analysis of the business account; a full bank deposit analysis is not required. All personal expenses found in the business bank accounts are considered compensation.

## Cost of Goods Sold

Cost of Goods Sold (COGS) is an accounting term to value inventory. Inventory is generally common in retail and manufacturing businesses rather than service businesses. For example, a painter may deduct the paint used in the business as COGS. However, a red flag is a service business with significant reported COGS.

$$\text{COGS} = \text{beginning inventory} + \text{purchases} - \text{ending inventory}$$

The calculation for Cost of Goods Sold is also found on Federal Schedule C, Part III, on page 2.

Businesses with inventory generally count inventory once each year towards the end of the year. The value of the inventory is reported as the current year's ending inventory and the next year's beginning inventory. Business engaged in manufacturing can include the cost of labor in their COGS; businesses engaged in the service industry do not include the cost of labor in COGS. On the Federal Schedule C, COGS is subtracted from gross receipts to calculate the year's gross profit. Once an expense is included in COGS, the expense cannot be deducted again as a business expense.

Additional information can be found in IRS Publication 334, Chapter 6. <http://www.irs.gov/pub/irs-pdf/p334.pdf>

## Capital Expenses

A capital expense is when a business spends money to buy an asset. The asset is usually a major expense for example a vehicle, building, machine, or other equipment.

Capital expenses are not expensed in the year of purchase but expensed as depreciation over the life of the asset.

### Depreciation

Depreciation is an accounting term to place a value on a book and tax expense related to the cost and life of an asset; depreciation is a non-cash expense. Depreciation is non-cash expense because *there is no actual cash outlay* – no immediate economic reality. In theory, assets will eventually need to be replaced; machines break and vehicles will need to be placed out of service.

For tax purposes, there is Section 179 depreciation, bonus depreciation, and accelerated depreciation. However, for child support income calculations, straight line depreciation is used. This means the depreciation reported on Federal Schedule C or Federal Form 1120S should be disregarded and depreciation is recalculated. Straight line depreciation is calculated as follows:

$$\text{Annual Depreciation} = \text{Cost} / \text{Useful Life}$$

The cost of an asset may be found on Federal Tax Form 4562, the statements or worksheets of the tax return (software or accountant generated), or from the receipt of purchase. Please note: Federal Form 4562 does not always contain all relevant information which is why it is typical to have statements to supplement the tax return. The statements will simply state the date of purchase, the cost, amounts expensed for Section 179, bonus, and accelerated for the current and previous years, as well as accumulated depreciation and current basis. "Basis" is an accounting and tax term that measures an asset's current value as cost less accumulated depreciation.

The useful life of assets can be determined from the tables in IRS Publication 946 Appendix B.

<http://www.irs.gov/pub/irs-pdf/p946.pdf>

## IRS Property Class Lives

<b>Property Class Recovery Period</b>	<b>Business Equipment</b>
3-year property	Tractor units and horses over two years old
5-year property	Cars, taxis, buses, trucks, computers, office machines (faxes, copiers, calculators, and so on), research equipment, and cattle
7-year property	Office furniture and fixtures
10-year property	Water transportation equipment, single-purpose agricultural or horticultural structures, and fruit- or nut-bearing vines and trees
15-year property	Land improvements, such as shrubbery, fences, roads, and bridges
20-year property	Farm buildings that are not agricultural or horticultural structures
27.5-year property	Residential rental property
39-year property	Nonresidential real estate, including a home office but not including the value of the land

### Records for Capital Expenses

The good news: you do not need to know the different types of depreciation or how they are calculated! Theoretically, you can add back the depreciation expense reported and recalculate the depreciation using straight line and use your calculation as the correct expense.

Depreciation expense is found on the front of the Federal Schedule C; there should also be a Federal Form 4562 for depreciation. Since Federal Form 4562 is limited in details, a more detailed list of information can be provided to substantiate the assets and depreciation expensed. From the information, the cost and useful life can be used to recalculate depreciation as straight line method. Be mindful of the date acquired, as an asset may be past its depreciable life.

## Example of Depreciation Detail

Depreciation Schedule for ABC Business								
Asset Description	Date Acquired	Method	Life	Sold?	Cost	Accum deprec 1/1/09	Current Depr	Accum Depr 12/31/09
Furniture	4/1/2006	200% DB	7 yrs	N	\$60,000.00	\$33,760.94	\$7,496.87	\$41,257.81
Spa Chair	1/1/2007	SL	5 yrs	N	\$6,950.00	\$6,950.00	\$0.00	\$6,950.00
Acura Vehicle	4/1/2005	SL	5 yrs	N	\$43,200.00	\$40,687.50	\$1,675.00	\$42,362.50

## IV. Looking Further at Gross Receipts

### What are Indirect Methods?

Indirect methods are techniques for reconstructing income when correct records do not exist.

### When to use Indirect Methods

Use indirect methods when obligors are not cooperating or the assets/income are suspicious.

Generally, it is relatively easy to determine the correct income and enforce support from wage earners (W2 employees). However, the following is aimed at less straightforward sources of income.

#### Indicators

A primary indicator of underreported income is consistent paper losses and/or low profit percentages without other sources of income to sustain those losses.

- A lifestyle that cannot be supported by reported income
- A business that continues to operate with losses year after year without a solution to correct the problem
- An increase in personal and/or business assets even though there are losses; especially assets that contribute to expanding a business
- Debt balances stay the same or decrease even though there are losses
- A discrepancy between business profit margins compared to industry averages. Industry averages can be found online at BizStats: <http://www.bizstats.com/industry-financials.php>

The above indicators are typical for income tax purposes. However, you may find in a divorce or child support scenario something different. One party may be highly motivated to protect their assets and manipulate their financial statements. You may very well encounter a successful thriving business that is suddenly losing money. The good news: the methodology for uncovering hidden income is the same.

# Authority to Use Indirect Methods

For child support purposes, Minnesota Statutes define income as follows.

## **Gross income under MS 518A.29 (a):**

Subject to the exclusions and deductions in this section, **gross income** includes any form of periodic payment to an individual, including, but not limited to, salaries, wages, commissions, self-employment **income** under [section 518A.30](#), workers' compensation, unemployment benefits, annuity payments, military and naval retirement, pension and disability payments, spousal maintenance received under a previous order or the current proceeding, Social Security or veterans benefits provided for a joint child under [section 518A.31](#), and potential **income** under [section 518A.32](#).

## **Income from Business or Self-Employment, MS 518A.30:**

For purposes of [section 518A.29](#), **income** from **self-employment** or operation of a **business**, including joint ownership of a partnership or closely held corporation, is defined as gross receipts minus costs of goods sold minus ordinary and necessary expenses required for **self-employment** or **business** operation. Specifically excluded from ordinary and necessary expenses are amounts allowable by the Internal Revenue Service for the accelerated component of depreciation expenses, investment tax credits, or any other **business** expenses determined by the court to be inappropriate or excessive for determining gross **income** for purposes of calculating child support. The person seeking to deduct an expense, including depreciation, has the burden of proving, if challenged, that the expense is ordinary and necessary.

## **Potential Income, MS 518A.32, subd. 1:**

**General.** This section applies to child support orders, including orders for past support or reimbursement of public assistance, issued under this chapter, chapter 256, 257, 518B, or 518C. If a parent is voluntarily unemployed, underemployed, or employed on a less than full-time basis, or there is no direct evidence of any **income**, child support must be calculated based on a determination of **potential income**. For purposes of this determination, it is rebuttably presumed that a parent can be gainfully employed on a full-time basis. As used in this section, "full time" means 40 hours of work in a week except in those industries, trades, or professions in which most employers, due to custom, practice, or agreement, use a normal work week of more or less than 40 hours in a week.

# Five Basic Indirect Methods of Reconstructing Income

1. Source and Application of Funds (Otherwise known as a Cash Transaction Account or "Cash-T")
  - a. Comparison of expenses to income
  - b. Incorporates the Personal Living Expense (PLE)
2. Bank Deposit
  - a. Sum of all bank deposits less non-income items such as bank transfers, gifts, loans, and insurance proceeds
3. Net Worth

- a. A change in assets and liabilities. Ex. Comparing assets/liabilities from 1/1 to 12/31
  - b. Sole reliance on this method alone is difficult
4. Percentage of Mark-up
    - a. Used in retail. Ex: percentage markup of convenience store inside sales
    - b. Outside of the scope of this presentation
  5. Unit and Volume
    - a. Used in retail. Ex: determining sales at a bar based on volume purchased
    - b. Outside of the scope of this presentation

We will focus on the Cash-T with PLE and a simplified bank deposits method.

## Recommended Steps

1. Research assets
2. Put together preliminary Cash-T with known information and a PLE using national averages
3. Stop and establish justifications to proceed with indirect methods. This involves establishing a lack of internal controls with the business and/or inherent risks associated with a cash intensive business.
  - a. A common example of lack of internal controls in small businesses is no segregation of duties. Ideally, one person would take in customer payments, another would deposit the funds, and another would reconcile the bank statements.
  - b. Controls can be determined through an interview, questionnaire, or business walk through.
  - c. The IRS has more information: [http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Business-Consultants-Audit-Techniques-Guide#\\_Toc280356466](http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Business-Consultants-Audit-Techniques-Guide#_Toc280356466)
4. Perform a bank deposits summary and analyze the activity in the bank statements
5. Fill in the Cash-T and PLE with actual figures from the bank statements or gained through 3<sup>rd</sup> party verification

### Step 1: Asset Research

- **Employment**—Occupation, employer and professional licenses held. This information can be found on a W2, paycheck, tax return, and DEED.
- **Real estate**—Real property owned. Review the mortgage balance owed and the current value of the asset to determine the equity, if any, and when payments are scheduled to end. County website searches and PLAT are helpful for MN property. However, for out of state property and property titled in a trusts' name can be found using a national public database such as Clear, a Thomson Reuters product, or Lexis Nexis.
- **Bank accounts**—Ideally, this information comes from the individual. However, wages are often directly deposited in to a bank account; this can be requested from the employer. This can be found as interest income (Federal Schedule B) of a tax return or from a federal wage and income transcript. For even less cooperative individuals, subpoenas for the last three payments made to trash, cable, and mortgage companies will help.
- **Motor vehicles**—This information is found from MN DPS DVS. However, vehicles titled in other states and a history of title transfer (if transferred to a related or private party) can be found from a public database service such as Clear. Review the balance owed and the value of assets to determine equitable interest and when payments are scheduled to end.
- **Credit cards**—This information should include the balance owed, credit limit and minimum payment. Review when the debts are scheduled to be paid in full. 4% of the individuals' monthly income is an allowable expense for monthly credit card expense or the actual credit card expense, whichever is less. This expense is

used on the PLE, Personal Living Expense. Finding out why the credit card debt exists might reveal life circumstances that should be taken into consideration. For example, a person may have lost a job and used credit cards for living expenses for a period of time or a family may have health care issues. Increasing debt can explain lifestyle issues and explains the source of maintaining a lifestyle. However, decreased debt is the result of a source of income.

- **Other obligations**—Home equity loans, personal or student loans, amounts owed to the IRS, and any amounts owed to others. These entries should include the amount owed, party receiving payment, and the amount paid each month. These items are included in the PLE, Personal Living Expense.

## Step 2.1: Personal Living Expense

Evaluate expenses to determine the Personal Living Expense (PLE); this figure will be used in the Cash-T. The preliminary Cash-T with the PLE may use estimated figures. More specifically, not all PLE items will be known and a national standard can be used. Allowable living expenses used by the IRS from the Bureau of Labor and Statistics can be found here: [http://www.irs.gov/pub/irs-utl/national\\_standards.pdf](http://www.irs.gov/pub/irs-utl/national_standards.pdf)

After completing a preliminary Cash-T and PLE, the information may not indicate unreported or underreported income. The preliminary result assists you in determining if a more detailed investigation is justified.

After the preliminary Cash-T and PLE is prepared and a decision has been made to continue the investigation, certain living expenses, such as real estate taxes paid, can be verified through third parties by searching online at the county website. Also, other expenses are revealed through an analysis of the bank statements, such as car payments and car insurance ACH payments in the bank statements. When possible, use the actual figures as opposed to estimated figures. Noting if the figures used are actual or estimated is recommended.

The basic categories in the PLE are food, housing, apparel and services, transportation, health care, entertainment, and other expenditures.



# Personal Living Expenses Worksheet

	Per BLS	Actual
<b>Expenditures</b>		
<b>Food/Beverages</b>		
1. Food at home		
2. Food away from home		
3. Alcoholic beverages		
4. <b>Total Food/Beverages (add lines 1 through 3)</b>		
<b>Housing</b>		
5. Mortgage interest and charges		
6. Property taxes		
7. Maintenance, repair, insurance, other expenses		
8. <b>Owned dwellings (add lines 5 through 7)</b>		
9. <b>Rented dwellings</b>		
10. <b>Other lodging</b>		
11. <b>Total Shelter (add lines 8 through 10)</b>		
12. Natural gas		
13. Electricity		
14. Fuel oil and other fuels		
15. Telephone		
16. Water and other public services		
17. <b>Total utilities, fuels, and public services (add lines 12 through 16)</b>		
18. <b>Household operations</b>		
19. <b>Housekeeping supplies</b>		
20. <b>Household furnishings and equipment</b>		
21. <b>Total Housing (add lines 11 and 17 through 20)</b>		
22. <b>Total Apparel and services</b>		
<b>Transportation</b>		
23. <b>Vehicle purchases (net outlay)</b>		
24. <b>Gasoline and motor oil</b>		
25. Vehicle finance charges		
26. Maintenance and repairs		
27. Vehicle insurance		
28. Vehicle rental, lease, license, other charges		
29. <b>Other vehicle expenses (add lines 25 through 28)</b>		
30. <b>Public transportation</b>		
31. <b>Total Transportation (add lines 23, 24, 29 and 30)</b>		
<b>Health care</b>		
32. Health insurance		
33. Medical services		
34. Drugs		
35. Medical supplies		
36. <b>Total Health Care (add lines 32 through 35)</b>		
37. <b>Total Entertainment</b>		
<b>Other Expenditures</b>		
38. Personal care products and services		
39. Reading and education		
40. Tobacco products and smoking supplies		
41. Miscellaneous		
42. Cash contributions		
43. Life, endowment, and other personal insurance		
44. Retirement, pensions, and Social Security		
45. <b>Total Other Expenditures (add lines 38 through 44)</b>		
46. <b>TOTAL EXPENDITURES</b>		

## Step 2.2: Cash-T

The basis of the method is a simple cash account based on available, received, and acquired personal and business information in which sources of income are debited (on the left side of the Cash-T) and expenditures are credited (on the right side of the Cash-T). When the total credits/expenditures exceed the total debits/income, the difference may represent an understatement of income.

The cash transaction or Cash-T method considers all transactions that affect cash.

The formula for the Cash-T method is:

**All Expenditures (credits)**  
**Less: All Sources of Cash (debits)**  
**Equals: Understatement of Income**

<u>Sources of Cash (debits)</u>	<u>Expenditures of Cash (credits)</u>
Gross receipts (business)	Business Expenses (excluding depreciation)
Gross wages	Rental Expenses (excluding depreciation)
Gross Rents	Personal Living Expense (PLE)
Miscellaneous income	Purchases of Assets
Interest income and dividends	Cash on hand at end of year
Cash on hand at beginning of year	Cash in banks at end of year
Cash in banks at beginning of year	Loan repayments
Nontaxable income (gifts, prizes, etc.)	
<b>=Total Sources of Income</b>	<b>=Total Expenditures</b>

## Cash-T with PLE Worksheet

CASH-T WITH PLE			
Name		Year	
ITEMS	DEBITS	ITEMS	CREDITS
WAGES		STATE/FED WITHHOLDING	
INTEREST INCOME		FICA WITHHOLDING	
TAXABLE		OTHER WITHHOLDINGS ON FORM W-2	
NONTAXABLE		ESTIMATED TAX PAYMENTS	
DIVIDENDS.....		TAX PAYMENTS ON PRIOR YEARS	
TAX REFUNDS PER RETURN		INVESTMENT INTEREST	
TAX REFUNDS ON ITR		SCHEDULE C PURCHASES	
ALIMONY RECEIVED....		SCHEDULE C EXPENSES	
SCHEDULE C RECEIPTS		(NET OF DEPRECIATION)	
SCHEDULE D - GROSS SALES		RENTAL EXPENSES	
SALE OF BUSINESS PROPERTY		(NET OF DEPRECIATION)	
(Form 4797)		SCHEDULE F EXPENSES	
IRA/PENSION DISTRIBUTIONS		(NET OF DEPRECIATION)	
RENTAL INCOME		ASSET/INVEST. PURCHASES	
SCHEDULE F RECEIPTS		FROM SCHEDULE D	
UNEMPLOYMENT COMPENSATION		FROM SALE OF RESIDENCE (FORM 2119)	
SOCIAL SECURITY BENEFITS		FROM FORM 4562 - DEPRECIATION	
OTHER INCOME:		FROM DMV RECORDS	
UNREPORTED IRMF AMOUNTS		CONTRACT AMOUNTS	
CASH DISTRIBUTIONS (IF AVAIL.)		LIFE INSURANCE PURCHASES	
FROM S-CORPORATIONS		CASH ON HAND - END OF YEAR	
FROM PARTNERSHIPS		ENDING BANK BALANCES	
FROM FIDUCIARIES		IRA, ANNUITIES & PENSIONS	
SALE OF PERSONAL RESIDENCE		Contributions	
SALE OF PERSONAL PROPERTY		PENALTY - EARLY SAVINGS WITHDRAWAL	
ADVANCED EITC		LOAN REPAYMENTS	
CHILD SUPPORT RECEIVED		BEGINNING CREDIT CARD BALANCES	
CASH ON HAND (BEG)..		PERSONAL CAPITAL ACQUISITIONS	
CASH IN BANKS (BEG).		<b>PERSONAL LIVING EXPENSES (PLE)</b>	
ENDING CREDIT CARD BALANCES		OTHER "CASH OUT" ITEMS	
LOAN PROCEEDS.....		Child Support	
NON-TAXABLE INCOME			
(INHERITANCES, GIFTS, ETC.)			
OTHER "CASH IN" ITEMS			
ACCRUAL BASIS TAXPAYERS:		ACCRUAL BASIS TAXPAYERS:	
ACCTS. RECEIVABLE 1/1		ACCTS. RECEIVABLE 12/31	
ACCTS. PAYABLE 12/31		ACCTS. PAYABLE 1/1	
TOTAL SOURCES:	\$0	TOTAL EXPENDITURES:	\$0
		LESS: TOTAL SOURCES:	\$0
			\$0
(OVERSTATEMENT) OR UNDERSTATEMENT OF INCOME:			→ \$0

### Step 3: STOP AND ANALYZE!

Take a deep breath, stop, and think. Does the preliminary Cash-T and PLE make sense? Is there an imbalance of income to expenses? Does there appear to be income from other sources? How much time will be needed to go forward? What is the expected recovery of the case? What information do you need to be able to complete a full bank deposit analysis and cash-T with PLE?

### Step 4: Bank Deposit Analysis

The Bank Deposit Method proves income through an analysis of bank deposits, cancelled checks, currency transactions, electronic debits, electronic transfers and credit to the bank accounts. The bank deposit method computes income by showing what happened to an individual's funds. It is based on the theory that if an individual receives money, only two things can happen: it can either be deposited or it can be spent.

The bank account analysis may supply leads to potential unreported income, not only from the amounts and frequency of deposits, but also from the sources of such deposits. It may also provide the disposition of these deposited funds (or lack of deposited funds) as well as the type of expenditures made and to whom. Account analysis may also lead, in turn, to other income sources.

Total deposits include amounts deposited from both income and non-income sources to all bank accounts maintained or controlled by the individual as well as deposits made to accounts in savings and loan companies, investment trusts, brokerage houses, and credit unions.

#### Gross Income Formula

<b>Total bank deposits</b>	<b>\$XXX</b>
<b>Less:</b>	
<b>Non-income receipts deposited</b>	<b><u>(XXX)</u></b>
<b>Net deposits resulting from income source receipts</b>	<b>\$XXX</b>

### Simple Bank Deposit Worksheet

Name									
Bank									
						CASH	Non taxable		
Year	Bal Beginning Balance	debit/ dr /withdrawals	credit/ cr/ deposits	balance	OUT	deposits	Transfers	Notes:	
Balance									
Jan									
Feb									
Mar									
Apr									
May									
Jun									
Jul									
Aug									
Sep									
Oct									
Nov									
Dec									
<b>Sub-total</b>									
<b>Add: Cashout</b>									
<b>Less: Non Tax. Dep</b>									
<b>Less: Transfers</b>									
<b>Total Deposits</b>									

### ***Items to Consider:***

1. Size of Deposits
2. Kind of Deposit – electronic, direct deposit, transfer, cash, check deposit with cash out
3. Frequency of Deposits
4. Location of Bank on Which the Check Was Drawn

### ***Steps to Bank Deposit Analysis:***

1. Total bank deposits – this includes the amounts shown on the bank statement and cash out items that do not reflect on the bank statement but are shown on a copy of the deposit slip
  - a. For example, a deposit slip may show a \$5,000 check deposited with \$1,000 cash out. The net deposit in the bank account is \$4,000 but \$5,000 of income was constructively received. The cash out column reflect the \$1,000 that was “cashed out”.
  - b. For business bank accounts, calculate the ratio of cash and check deposits to credit card deposits. A cash intensive business should have more than 50% of deposits in cash.
2. Non-income items deposited – these are totaled and eliminated from step one.
  - a. This can include returned checks, gifts, prizes, bank adjustment, and insurance proceeds
3. Identify personal expenses
  - a. These amounts can be summed by category and included in the PLE as actual expenses
  - b. Look for lack of personal expenses. Individuals may be paying cash for usual household expenses such as groceries and gas.

### ***Common Errors:***

- Not identifying all bank accounts, business and personal
- Not capturing accurate personal living expenses or accepting unrealistically low personal living expenses
- *Understanding that not all cash will go through the bank accounts.* Many cash basis individuals use cash to pay for gas and groceries. The cash will not be reflected in the analysis, but the actual expenses summed from the bank accounts should reflect low expenses to items paid in cash. The PLE will reveal cash spent; cash that does not necessarily flow through the bank accounts.
  - For example, you may total bank card and checks written to grocery stores and find only \$200 in known expenses for the year for a family of five – this should raise a red flag!
- ATM and other withdrawals are not added or subtracted to or from the total deposits

### **Step 5: Lather, Rinse, Repeat**

Use actual figures from Step 4's bank statement review to fill in the Cash-T and PLE from Step 2. The bank statements will show the actual mortgage or rent payments and other expenses. Initially the PLE included an IRS or BLS estimate of household expenses; this is an opportunity to fill in the blanks.

## **Analyzing the Results**

The Cash-T results and the bank deposits results will differ. Again, the results will be different!

The PLE demonstrates the amount of money needed to maintain the subject's household for the year. Some of the figures may be estimated using national standards and some of the figures will be actual verified amounts from third

parties and payments made through the bank accounts. The PLE flows onto the Cash-T. The Cash-T reflects expenditures for the year. Simply put, the Cash-T with the PLE shows known cash in and known cash out.

The bank deposits analysis affirms the amount of cash flowing through the bank accounts for the year. The composition of the bank deposits can demonstrate an imbalanced ratio of cash to credit card sales. And client checks deposited to personal accounts rather than business accounts can be a badge of fraud. Simply put, the bank deposits method shows the money moving through bank accounts.

Both methods yield an incorrect number. However, the number initially reported by the obligor is also incorrect. The amount of income earned is an unknown by all parties. The bank deposits are often the lowest figure to estimate income; as this reflects money going through the bank account and not money paying for expenses in cash. The PLE, Personal Living Expenses, is demonstrating the amount of money paid for known household expenses. The Cash-T with the PLE attempts to capture all known sources of income against expenses both personal and business in nature – this imbalance can also be a low figure for reconstructing income. The Cash-T with PLE does not account for purchases not known or cash hoarded.

## Arguments to Indirect Methods (or rather the findings)

1. The most common argument is loans from family or friends.
  - a. There could be an explanation for deposits that isn't typical income such as loan proceeds, insurance proceeds, gifts, and inheritances. Don't discount an explanation of a home equity loan or credit card debt as an explanation for someone making both business and personal expenses – this is easily documented.
  - b. However, a common example is simple money laundering for tax purposes.
    - i. For example, our subject wants to buy a \$50k vehicle. The subject gives his brother, or other family member, \$55k in cash and then the brother turns around and writes a check to the subject for \$50k to purchase the vehicle. Get documentation of the transaction; see if the transaction actually happened. After documentation, subpoena the lender for interview/testimony. Intent between two parties is difficult to overcome if the other party agrees this is a loan. Or the other party may not show, after receiving a subpoena for testimony. Also, research the financial ability of the other party to loan money.
2. Cash hoard (this is the "cash under the mattress" defense).
  - a. Ask how much cash was on hand at the beginning of the year, how it was accumulated, who knew about or saw the cash hoard, and what was it spent on. Usually there is no direct corroborating evidence – nothing can be verified.
3. The computation is inaccurate
  - a. When the methods are prepared carefully, there is no argument here. Also, using more than one method debunks this argument.

## Additional Resources

More information about the methods, interviews, specific industries, and national living expenses can be found below.

IRS audit technique guides (ATGs). These include theory, methods, and interview techniques:

<http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Audit-Techniques-Guides-ATGs>

IRS cash intensive business ATG: <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Cash-Intensive-Businesses-Audit-Techniques-Guide-Table-of-Contents>

IRS allowable living expenses from the Bureau of Labor and Statistics (Used in the PLE – Personal Living Expenses):

[http://www.irs.gov/pub/irs-utl/national\\_standards.pdf](http://www.irs.gov/pub/irs-utl/national_standards.pdf)

BizStats is an online resource for looking at industry averages. According to its website, BizStats collects and analyzes public data to provide a free online source for small business statistics: <http://www.bizstats.com/industry-financials.php>

## Final Thoughts

Indirectly determining income can be outside the comfort zone of a detail oriented person. That's ok. Neither the subject nor investigator knows the real income amount. What the indirect method gives you is a more realistic income amount that can either be a final figure or the starting point for negotiations.