

# The Underground Economy

# What is it?

- ▶ According to a 2007 IRS Report, the ‘underground economy’ is “the value of goods and services that elude official measurement.”

# How is it?

## ▶ Unreported Income

- Direct cash payments

## ▶ Underreported Income

- Reported profit decreased by exaggerated expenses

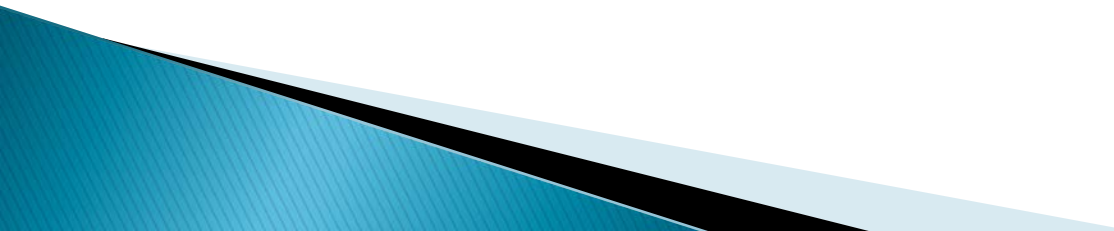
# Who is it?



The truly 'off the radar'

Successful business owners

# Difficulties

- ▶ Our collection and enforcement remedies are largely tied to reported income and 'legitimate means'
    - AIW, tax intercepts, FIDM levies, drivers/rec/occupational license suspensions
  - ▶ Underground economy creates necessary reliance on voluntary payments
    - Requires obligor to obtain check / money order, envelope, postage
- 

# Focused Efforts



No magical method  
to get cash-in-hand  
from the true 'off  
the radar' obligors!

# Focused Efforts

Take a harder look  
at underreported  
income

**SCHEDULE C**  
**(Form 1040)**

**Profit or Loss From Business**  
(Sole Proprietorship)

OMB No. 1545-0047  
2013  
Attachment  
Sequence No. 09

Department of the Treasury  
Internal Revenue Service (IRS)

▶ For information on Schedule C and its instructions, go to [www.irs.gov/schedulec](http://www.irs.gov/schedulec).  
▶ Attach to Form 1040, 1040NR, or 1041; partnerships generally must file Form 1065.

Name of proprietor  
**J.M. Shady**

Principal business or profession, including product or service (see instructions)  
**Residential and commercial lawn and tree maintenance**

Business name (If no separate business name, leave blank.)  
**Shady Tree and Lawn Service**

Business address (including suite or room no.) ▶ **123 Ave.**

City, town or post office, state, and ZIP code

Accounting method (1) ☐ Cash (2) ☐ Accrual (3) ☐ Other (specify) ▶

Did you "materially participate" in the operation of this business during 2013? If "No," see instructions for limit on losses. ☐ Yes ☐ No

If you started or acquired this business during 2013, check here ☐ Yes ☐ No

Did you make any payments in 2013 that would require you to file Form(s) 1066? (see instructions) ☐ Yes ☐ No

If "Yes," did you or will you file required Form(s) 1066? ☐ Yes ☐ No

**Part I Income**

1	Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-9 and the "Statutory employee" box on that form was checked <input type="checkbox"/>	1	\$1,989
2	Returns and allowances	2	0
3	Subtract line 2 from line 1	3	\$1,989
4	Cost of goods sold (from line 4)	4	16,898
5	Gross profit. Subtract line 4 from line 3	5	75,091
6	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6	
7	Gross income. Add lines 5 and 6	7	75,091

**Part II Expenses**

Enter expenses for business use of your home only on line 30.

8	Advertising	8	3,300	18	Office expenses (see instructions)	18	1,800
9	Car and truck expenses (see instructions)	9	0	19	Pension and profit-sharing plans	19	
10	Commissions and fees	10		20	Rent or lease (see instructions)	20	600
11	Contract labor (see instructions)	11		21	Vehicle, machinery, and equipment	21	200
12	Depreciation	12		22	Other business property	22	1,390
13	Depreciation and section 179 expense deduction (not included in Part II) (see instructions)	13	10,722	23	Repairs and maintenance	23	1,710
14	Employee benefit programs (other than on line 19)	14		24	Supplies (not included in Part II)	24	6,130
15	Insurance (other than health)	15	4,220	25	Taxes and licenses	25	
16	Interest	16		26	Travel, meals, and entertainment:	26	
17	Mortgage (paid to banks, etc.)	17		a	Travel	26a	
18	Legal and professional services	18	1,440	b	Deductible meals and entertainment (see instructions)	26b	
19		19	410	27	Utilities	27	20,513
20		20		28	Wages (less employment credits)	28	
21		21		29	Other expenses (from line 48)	29	
22		22		30	Reserved for future use	30	
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**Net profit or (loss).** Subtract line 30 from line 29.

If a profit, enter on both Form 1040, line 12 (or Form 1040NR, line 13) and on Schedule SE, line 2. If you checked the box on line 1, see instructions. Estates and trusts, enter on Form 1041, line 3. If a loss, you must go to line 32.

If you have a loss, check the box that describes your investment in this activity (see instructions).

If you checked box 1, enter the loss on both Form 1040, line 12, (or Form 1040NR, line 13) and on Schedule SE, line 2. If you checked the box on line 1, see the line 31 instructions. Estates and trusts, enter on Form 1041, line 3.

If you checked box 2, you must attach Form 6198. Your loss may be limited.

32a ☐ All investment is at risk.  
32b ☐ Some investment is not at risk.

For Paperwork Reduction Act Notice, see the separate instructions. Schedule C (Form 1040) 2013

# Income

## ► 518A.29(a)

- . . . gross income includes any form of periodic payment to an individual. . .



# Income

## ► 518A.30

- For purposes of 518A.39. .  
.defined as gross receipts minus  
costs of goods sold minus  
ordinary and necessary  
expenses. . .

# Discovery

## ▶ Minn.R.Gen.P. 361.02

- If a complaint or motion has been served and filed in the expedited process, a party may request any of the documents listed below. . .
- Copies of last three months of paystubs
- A copy of last two years State and Federal income tax returns with all schedules and attachments, including Schedule Cs, W-2s and/or 1099s

# Getting the Right Order

- ▶ Modification / Establishment Hearings
  - Obtain tax documents, bank records
  - Take a hard look at Schedule C and supporting schedules
  - Look at bank records for what's coming in and and what's going out
  - Cross examine obligor
    - PERSONAL EXPENSES and ASSETS – boats, trucks, ATVs, campers, fish houses

# Enforcing the Order

## ▶ Administrative Framework

- FIDM – ‘Business accounts’ of sole proprietorship not exempt from levy
  - See Village at Izaty’s v. Jaskowick, 2010 WL 10423
- AIW – Applies to payor of funds and not limited to W-2 employer
- License Suspensions – Driver’s license, recreational licenses

# Enforcing the Order

- ▶ Contempt Framework
  - At least get them to court (either voluntary or through writ of attachment)
  - Keep them coming back – **build the relationship**
  - Use not coming back to court as motivation to pay
  - Don't waste too much time/resources on the off-the-radar obligors!

# Underreported Income: Income or Expense?

- ▶ 518A.30 Income From Self-Employment
  - Gross receipts minus costs of goods sold minus ordinary and necessary business expenses

**Gross Receipts (GR)**

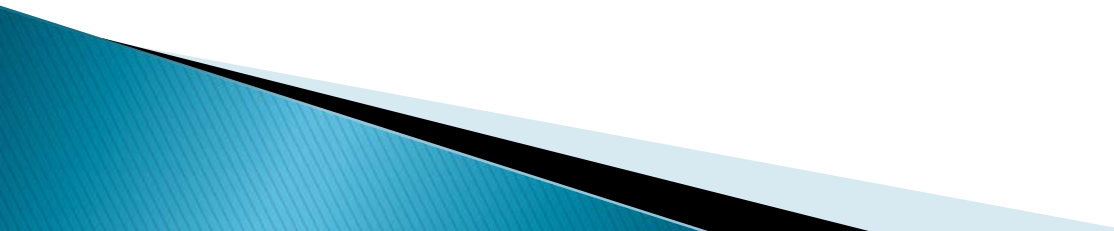
- **Cost of Goods Sold (COGS)**
- **Ordinary and Necessary Expenses**

**Income from Self-Employment**

# Expenses

- ▶ Cost of Goods Sold (COGS)
- ▶ Ordinary and Necessary
- ▶ Capital Expenses
- ▶ Personal Expenses
  - No!

# Cost of Good Sold

- ▶ Cost of Goods Sold (COGS) is inventory
  - ▶ Retail=Yes
    - Examples: restaurants, bars, liquor stores, bakery
  - ▶ Service=No!
    - Examples: Lawn/snow maintenance, painter, dog walker
- 



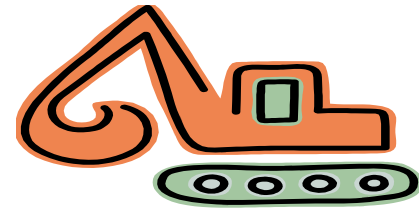
# Ordinary and Necessary Expenses

- ▶ What is it?
- ▶ What isn't it?
- ▶ BizStats is your online resource

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		

# Capital Expenses

- ▶ Vehicles, buildings, machines, equipment



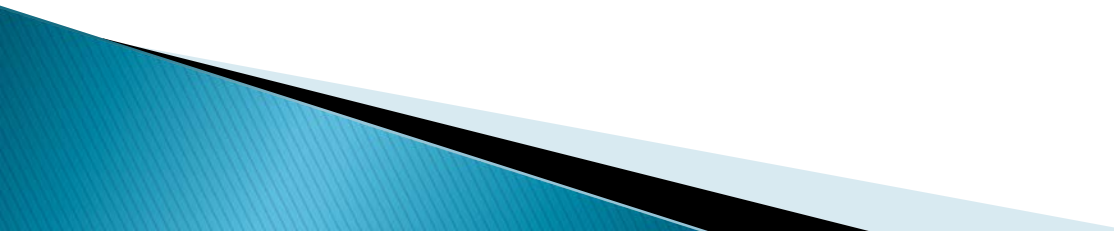
- ▶ Depreciation

- Section 179 expense, special bonus depreciation, accelerated depreciation= Who cares

- Straight line depreciation

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

# Officer Compensation Issues: Personal Expenses

- ▶ The unreported income is found in the business bank accounts
  - ▶ Owners will write checks for personal expenses  
ex: mortgage payments, credit card payments,  
and car payments
  - ▶ All personal expenses found in the business bank accounts are considered income
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# Challenge Expenses

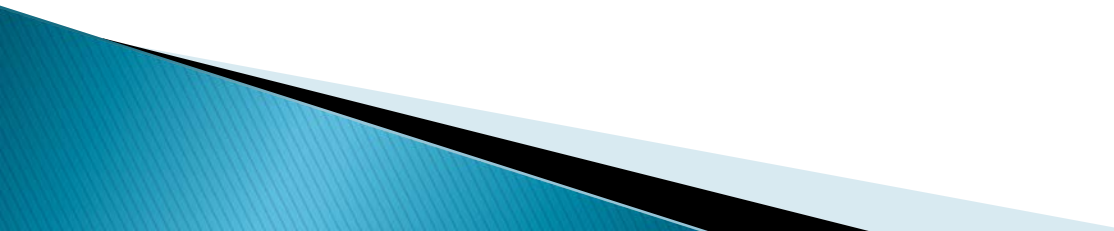
- ▶ Vehicle Expenses
  - Actual expense vs. Standard mileage rate
  - Not both!
- ▶ Bank Statements
  - Look for personal expenses
- ▶ Copies of checks, Receipts, Invoices




# Tackling the Income Gross Receipts/Gross Sales

## Indirect Methods:


Indirect methods are techniques for reconstructing income when records do not exist or appear questionable

- ▶ These methods have been around for years
  - ▶ Used by the IRS
  - ▶ Upheld in court
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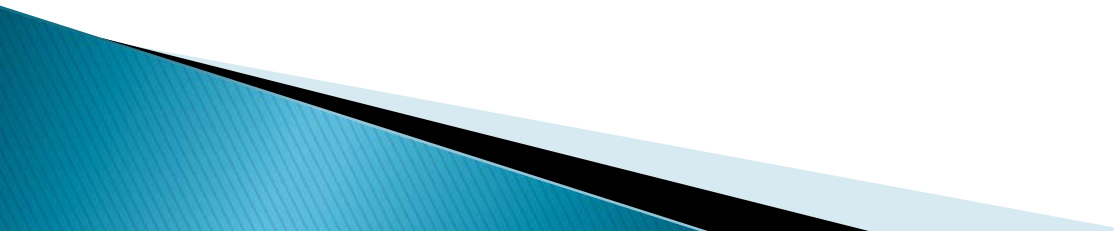
# The Methods

- ▶ Source and Application of Funds
    - Called a Cash Transaction Account or Cash-T
    - Includes Personal Living Expenses (PLE)
  - ▶ Bank Deposit
    - Sum of bank deposits less non-income items
  - ▶ Net Worth
    - Calculates the change in assets and liabilities
  - ▶ Percentage of Mark-up
    - Calculation for retail markup
  - ▶ Unit and Volume
    - Calculation for retail
- 

# The Steps

1. Research assets and available information
  2. Put together a preliminary Cash-T with personal living expenses (PLE)
  3. Stop! Justify going forward and establish lack of internal controls.
  4. Compile a bank deposit summary and analysis
  5. Fill in the preliminary Cash-T and PLE with actual figures from the bank statements and/or interview
- 

# Resources

- ▶ IRS Audit Technique Guides (ATGs)
  - ▶ BizStats – online business ratios by industry
  - ▶ Bureau of Labor and Statistics (BLS)
  - ▶ PACER for bankruptcy schedules
  - ▶ County Websites
  - ▶ Public database search software ex: Clear and Lexis Nexis
- 



# The Cash-T


- ▶ Wages
- ▶ Gross business receipts
- ▶ Interest and dividends
- ▶ Rents
- ▶ Other sources of income ex:  
inheritance, gifts,  
prizes

- ▶ Personal expenses (PLE)
- ▶ Business expenses
- ▶ Loan repayments
- ▶ Asset purchases

Sources of Cash

Cash Expenditures

# Personal Living Expense (PLE)

- ▶ PLE is included in the Cash-T cash expenditures
  - ▶ Categories include food, housing, apparel and services, transportation, health care, entertainment, and other expenditures
  - ▶ Start with a preliminary PLE using known figures and national standards then use actual figures when known
- 

		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		

# Bank Deposit Analysis

## Gross Income Formula

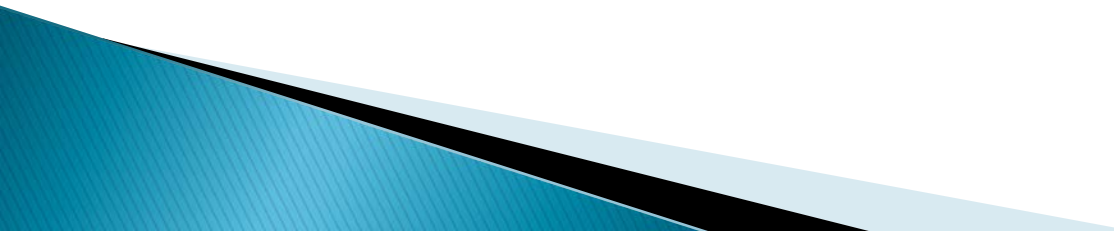
Total bank deposits	\$xxxx.xx
Less:	
Non-income items deposited	(\$xxxx.xx)
<hr/>	
Net income source deposits	\$xxxx.xx

\*\*Not all cash will go through bank accounts, but the some of those expenditures will be reflected in the PLE\*\*

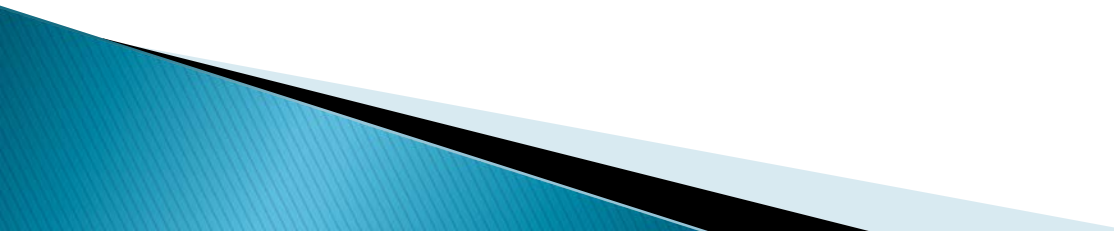


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# Analyzing the Results

- ▶  $PLE = \text{Household expenses}$
  - ▶  $\text{Cash-T} = \text{Accounted for total annual expenses}$
  - ▶  $\text{Bank Deposits Analysis} = \text{Cash run through the bank accounts (if it is deposited)}$
- 

# Common Arguments

- ▶ Loans
  - ▶ Cash hoard
  - ▶ Gift
  - ▶ The income determination is inaccurate
- 

# The End!

## Your Presenters:

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