

# The Underground Economy

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### What is it?

▶ According to a 2007 IRS Report, the 'underground economy' is "the value of goods and services that elude official measurement."

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### How is it?

▶ **Unreported Income**

- Direct cash payments

▶ **Underreported Income**

- Reported profit decreased by exaggerated expenses

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### Who is it?



The truly 'off the radar'

Successful business owners

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### 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

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### Focused Efforts



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

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### Focused Efforts



Take a harder look at underreported income

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### Income

▶ 518A.29(a)

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

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### Income

▶ 518A.30

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

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## 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

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## 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

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## 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

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## 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!

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## 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**

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## Expenses

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

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## 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

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## 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)	20a
11 Contract labor (see instructions)	11	a Vehicles, machines, and equipment	20a
12 Depreciation	12	b Other business property	20b
13 Depreciation and section 179 expense (depreciation not included in Part III) (see instructions)	13	21 Repairs and maintenance	21
14 Employee benefit programs (other than on line 15)	14	22 Supplies (not included in Part III)	22
15 Insurance (other than health)	15	23 Taxes and licenses	23
16 Interest	16	24 Travel, meals, and entertainment	24a
a Mortgage (paid to bank, 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 4)	27a
		b Reserved for future use	27b

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## Capital Expenses

- ▶ Vehicles, buildings, machines, equipment



- ▶ Depreciation
  - Section 179 expense, special bonus depreciation, accelerated depreciation= Who cares
  - Straight line depreciation  
**Annual Depreciation = Cost / Useful Life**

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### 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



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### 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

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## 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

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## 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

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### 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

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### 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

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Expenditures	Per IRS	Actual
<b>Food/Beverages</b>		
F1. Food at home		
F2. Food away from home		
F3. Alcohol beverages		
F4. <b>Total Food/Beverages (add lines F1 through F3)</b>		
<b>Housing</b>		
H1. Mortgage interest and charges		
H2. Property taxes		
H3. Maintenance, repair, insurance, other expenses		
H4. <b>Owned dwellings (add lines H1 through H3)</b>		
H5. <b>Rented dwellings</b>		
H6. <b>Other lodging</b>		
H7. <b>Total Shelter (add lines H4 through H6)</b>		
H8. Dues and fees		
H9. Fuel oil and other fuels		
H10. Telephone		
H11. Water and other public services		
H12. <b>Total utilities, fees, and public services (add lines H8 through H11)</b>		
H13. <b>Household operations</b>		
H14. Household supplies		
H15. <b>Household furnishings and equipment</b>		
H16. <b>Total Housing (add lines H7 and H12 through H15)</b>		
<b>Total Apparel and services</b>		
<b>Transportation</b>		
T1. <b>Vehicle purchases (net outlay)</b>		
T2. Gasoline and motor oil		
T3. Vehicle license charges		
T4. Maintenance and repairs		
T5. Vehicle insurance		
T6. Vehicle rental, lease, license, other charges		
T7. <b>Other vehicle expenses (add lines T5 through T8)</b>		
T8. <b>Public transportation (add lines T3, T4, T6, T7 and T8)</b>		
<b>Health care</b>		
H17. Health insurance		
H18. Medical services		
H19. Drugs		
H20. Medical supplies		
H21. <b>Total Health Care (add lines H17 through H20)</b>		
<b>Total Entertainment</b>		
<b>Other Expenditures</b>		
O1. Personal care products and services		
O2. Fueling and education		
O3. Tobacco products and smoking supplies		
O4. Miscellaneous		
O5. Cash contributions		

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## Bank Deposit Analysis

### Gross Income Formula

Total bank deposits           \$xxxx.xx  
 Less:  
Non-income items deposited   (\$xxxx.xx)  
 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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Name									
Bank									
Year	Bal	DEBIT or	CREDIT or	Balance	CASH	Non taxable			
	Beginning	Withdrawals	deposits		OUT	deposits	Transfers	Notes	
Balance									
Jan									
Feb									
Mar									
Apr									
May									
Jun									
Jul									
Aug									
Sep									
Oct									
Nov									
Dec									
Sub-Total									
Add: Cashout									
Less: Non Tax. Dep.									
Less: Transfers									
Total Deposits									

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## Analyzing the Results

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

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## Common Arguments

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

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## The End!

Your Presenters:

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