

Cash Intensive Businesses Audit Techniques Guide - Chapter 8 - The Underground Economy

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Definition of the Underground Economy

The underground economy represents income earned under the table and off the books. It can include legal and illegal, or black market, goods, including drug sales, money laundering and warehouse banking schemes. The underground economy is characterized by small, single, entrepreneurial businesses that can receive payment for their goods or services in the form of cash or bartered goods. The main goal is to avoid reporting income and paying taxes to governments.

Areas for potential abuse include the house with the perpetual yard sales, eBay sellers, craft fairs, selling homemade tamales, doing car repairs in the backyard, collecting cans and bottles for recycling, selling goods at pawn shops, day laborers on street corners.

The underground economy entrepreneur is not a business owner reporting small profits while living beyond all visible means. The underground economy entrepreneur is actively working to maintain a low economic level that does not draw attention. Some may hold a daytime job and operate in the underground by having a sideline business for unreported cash.

Individuals who participate in the underground economy want to avoid government regulations and may not be licensed in their trades. For example, a woman may offer to cut and style hair in her home for \$10 in cash, while a licensed stylist will charge \$30 for the same haircut in a salon. Or, a tree trimmer will charge only \$375 because the state requires licensing for jobs over \$400. In this case, the hair stylist and the tree trimmer can get by with the smaller earnings because they do not carry the overhead costs or the tax responsibilities.

The underground worker capitalizes on the “tax wedge” which is the difference between labor costs paid by an employer (gross wages) and the net wage received by an employee. An employer will pay wages of \$50 per hour, which includes payments to FICA, FUTA, Medicare, retirement benefits, workers compensation insurance, etc., but the employee will net a wage of only \$30 per hour. In the underground economy the same worker will charge \$30 per hour, cash, for the same work and the net result will be the same.

The underground worker can usually live on less income because no Federal or State income taxes, worker compensation taxes, payroll taxes, insurance, or social security payments are made. An undergrounder earning \$40,000 can provide his family with the same lifestyle a wage earner can provide with \$60,000. As a result, with very little overhead, they can provide their services at a lower cost. This will be attractive to other entrepreneurs who need to cut costs, and in a sluggish economy, to consumers hoping to stretch their buying dollars.

Whenever income is not subject to information reporting or cannot be verified by a third party there is a risk that some or all of it may not be reported. Hand in hand with unreported income is the possibility that bona fide net business income will be understated due to excess expenses, either personal or the expenses to produce the unreported income.

Traits of an Underground Worker

- Will keep a low economic profile to avoid suspicion. Unlike the typical under reporter who uses the business to pay for a brand new F350 pickup truck with sport tires, wheels and leather interior, the undergrounder will drive an older vehicle that appears to be in disrepair and will live in an older home in a lower income neighborhood. Both will probably be paid for in full.
- Can be found through word of mouth or will advertise in local free papers. An off the books hairstylist can be contacted through the local beauty supply store, or a cash plumber can be contacted through the local pipe supply outlet. The undergrounder relies on these sources to advertise his services.
- Will use an answering machine to screen calls so customers must provide their own telephone number or address before receiving a call back. This is because the undergrounder only accepts work when the money is needed, and because it allows the undergrounder to learn more about the customer before accepting a job.
- May use a postal box to protect the residence from scrutiny.
- Will engage in a trade that has minimal investment and overhead.
- Will not maintain a checking account or will not make significant deposits to a checking account. If a checking account is used, the underground funds will not be deposited. Is there is legitimate earned income that will be the source of any bank deposits?
- Will cash checks paid for services at a bank (without depositing the funds), or at a check cashing service.
- Will receive cash for services or goods. If work is performed for a large business that requires a SSN, the SSN provided will be phony or the worker will make up a corporate name so no information reporting is required.
- Will be characterized by resourcefulness, always alert for cash earnings, and usually is not limited to just one income source. A moving business will report receipts made by check, but cash payments, and cash received from used car sales is never deposited. A restaurant will report credit card receipts, but cash payments and sales from seasonal Christmas trees are never deposited.
- May receive government benefits, such as Welfare, EITC, Unemployment Compensation, disability or SS Income.
- Will pay personal living expenses in cash or by money order.
- May not have insurance. Business liability insurance can be costly and undergrounders will eliminate this cost, as well as vehicle insurance (if possible) and worker compensation. Helpers will be unreported and paid in cash.
- Will own a safe.

Examples of Possible Underground Activities

Used car sales

Used car sales are attractive to the undergrounder. Used cars are frequently sold without financing or can be financed by the seller over a short period. No bank or lending institution will be involved. In some cases, title is never transferred to the undergrounder after purchase to avoid any paper trail.

An individual making fewer than 25 sales per year may go undetected, though in many states this exceeds the limit requiring a state license. Used cars can be purchased for cash and turned over quickly. If there is ever an inventory of vehicles, they will be stored in various places- in the undergrounder's backyard, a friend's vacant lot or a relative's business parking lot.

This is a successful underground activity because new car buyers research before buying. They will use the internet to find the best deal, and may want to inspect the invoice, but used car buyers have only the Kelly Blue Book for reference and never know what was paid by the seller to acquire the car. The seller's profit on these sales can be significant.

Only once the deal is made, does the buyer realize the seller's name is not on the title. However, the seller will have a signed bill of sale from the titled owner, so the sale is valid and the title is not contested.

Child care/House cleaning/Pet sitting

Home businesses are attractive to the undergrounder. A stay at home mother, possibly on the welfare rolls, can earn extra, unreported, cash caring for neighborhood children. An elderly person, already earning social security benefits, can supplement their lifestyle by cleaning houses for working families. Single individuals often pet sit in the pet owner's homes, using their electricity, water, television, etc.

In most cases, overhead will be minimal because the customer provides all necessary supplies: snacks and clothes for children, mops and dust rags, dog food and grooming tools, etc. The undergrounder's primary purpose is to earn money, not to use time and money purchasing supplies.

Tree trimming/Hauling

Handyman businesses can be easily performed by an able bodied undergrounder. Many working people do not have the time or equipment to haul away large disposal items or to do large yard work projects.

These undergrounder's will generally estimate a flat job rate. In some states a tree trimmer must be licensed if charges exceed a particular dollar amount, for example, in California, if the job is estimated to cost more than \$400 a state license is required. In that case, the undergrounder will consistently charge \$375-\$395 per job.

Haulers may earn additional cash by selling the disposal goods to salvagers or thrift stores.

Construction workers

Unlicensed tradesmen can earn cash income by doing small construction jobs such as building a patio, doing electrical wiring, repair or install plumbing.

Locating Underground Economy Workers

Workers in the underground economy will take extreme care to make sure income cannot be reported on Forms 1099. They will try to always get payments in cash, but if that is impossible, they will provide a false social security number. The undergrounder knows that social security numbers cannot be immediately verified and will not accept any further work from that payor. Another tactic the undergrounder may use is to explain that he or she is the sole shareholder in a corporation with the same name, i.e. John Smith Plumbing (just make it out to John Smith.)

The best way to locate an undergrounder is through cash invoices found in related examinations. When the examiner encounters payments for goods or services made in cash and verified by questionable, possibly handwritten, invoices, it is very likely the taxpayer paid an undergrounder to do the work. Further questions should be asked to determine how the taxpayer located the underground worker, and if the worker is known to work for other local businesses, or if they worked on personal jobs for the taxpayer.

If the examiner follows up and determines the undergrounder's home is not extravagant, do not be dissuaded. Even a small economic lifestyle will cost money to maintain, and it may be deceptive because cash expenditures and cash accumulation are not immediately evident. The undergrounder's lifestyle will still require more income than what is reported.

Underground economy workers can be found on community bulletin boards. Theirs will be the handwritten 3x5 cards, or the business cards that do not list a license number when needed. Because they will not advertise in the typical ways, the undergrounder will make flyers to leave on doors and will rely on contacts made at donut shops and local restaurants. Remember, the underground entrepreneur will frequent local spots and rely on local contacts.

They will be known to legitimate businesses that will send work their way when a job is too small or labor intensive for the legitimate business.

Undergrounders can best be identified through acquisitions. The most lucrative time to locate underground economy workers is when they use their cash to make significant purchases. The nature of the business is that large amounts of cash are accumulated, but must be used very carefully. Vacations can be taken if expenses can be paid in cash. Gambling is a good diversion for the cash earner and any illegal activities, like drug purchases, always accept cash. But, eventually the undergrounder will want to enjoy the earnings or invest them, and this is the time for identification.

- Real estate (usually vacant land) will be purchased from private parties, so any large cash transactions remain hidden, but the title transfer will be recorded. Real estate may also be purchased out of the home state in an effort to shield the purchase.
- If there is a legitimate business that reports constant losses, hidden funds may be hidden in inventory. Unreported profits can be used to purchase additional inventory. The examiner should always inspect the physical inventory to see if it is consistent with the reported inventory. It is unlikely the undergrounder will provide their inventory records,

so the examiner must rely on their own experience to determine if the inventory is understated.

- Auto dealers almost always report large cash transactions, but a private party will accept cash over \$10,000 without making a report. Any new, sports or luxury vehicle will be kept hidden in a closed garage or another location.

Audit Techniques

- Comparative Analysis of assets and interest- Accumulation of cash could be identified by a multiple year analysis of an individual's assets and interest expense. An increase in assets without additional indebtedness and with too little sources of income suggests hidden income is available from some source.
- Barter Activity- In the underground economy goods and services are easily traded between individuals. When the undergrounder acquires assets (a used tractor, work truck, computer) or services (house gets painted, car seats reupholstered) this is income earned in the underground economy.
- Test Checks Written- Analyze the checks written from known bank accounts. Prepare a spreadsheet with each month (Jan, Feb, Mar, etc.) across the top and normal personal expenses down the first column (Mortgage, Electricity, etc.). Simply place a check mark for each month where a check is written to pay for the personal expense. This will show the amount of expenses that must have been paid in cash, and the examiner can begin questioning where the cash originated and how else was it spent.
- Cash Transaction Report- Check the current year, in addition to the two prior and two subsequent years. Prior and subsequent year purchases will show there was income available and how it was spent. These clues can lead the examiner to other discoveries.
- Loan Applications- If any loans were applied for, the undergrounder may have identified a source of income and these applications should always be secured by the examiner. Even prior year information is helpful and can lead the examiner to discover the source and use of hidden income. In contrast, a lack of debt where there should be some, (i.e. mortgage, car payments, credit cards) indicates an ability to easily afford the lifestyle.
- Civil, Criminal and Family Court- Determine if any lawsuits were filed against the individual. Creditors or wronged business associates will list known assets or pledged collateral in court filings. Divorces can disclose hidden income or assets.
- Third Party Contacts- Possible business associates, former spouses, and creditors can all be contacted for information.