DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

SEP 29 2000

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MEMORANDUM FOR THOMAS R. BURGER
DIRECTOR, OETAC
OP:EX:ST:ET

FROM: Jerry E. Holmes, Branch Chief
TEGE:EOEG:ET2

SUBJECT: Tip Validation

QUESTIONS

1. Does a tip rate validation inspection or compliance review for purposes of a Tip Rate Determination Agreement (TRDA) or Tip Reporting Alternative Commitment (TRAC) constitute an examination of books and records for purposes of section 7605(b) of the Internal Revenue Code (Code).

2. Does a tip rate validation inspection or compliance review for purposes of TRDA or TRAC constitute a prior audit for purposes of section 530 of the Revenue Act of 1978 (section 530)?

FACTS

As part of its Tip Rate Determination and Education Program, the Service currently enters into two standard agreements with employers of tipped employees, TRAC and TRDA.

TRDA is an agreement initially developed by the Service that requires 75 percent of tipped employees of a participating employer to report tips at a preestablished percent of gross receipts. For purposes of the agreement, a participating employer establishes an average tip rate on the basis of receipts for a six-month period. The Service must agree with the rate established by the employer before it will sign a TRDA. In the process of reviewing the tip rate determined by the employer and arriving at a mutually agreed-upon rate, the Service engages in a tip rate validation inspection. This process involves inspection of books and records, including records of hours worked by tipped employees, sales journal, cash and charge receipts. If the employer and the IRS

agree upon a rate and enter into an agreement, the employer is then required to secure Tipped Employee Participation Agreements (TEPAs) from at least 75 percent of its employees to report tips at or above the established rate and must maintain the rate of employee participation at 75 percent or more.

The TRDA used to involve an assessment of employer FICA tax on unreported tip income for the six-month period which was used to determine the tip rate. Consequently there used to be an assessment of FICA tax on unreported tips as a condition of entry into a TRDA. The TRDA has been revised to eliminate this provision. This distinction is important because an examination of books and records in connection with a tax assessment is an audit for section 7605(b) purposes. Under the latest TRDA, the employer does not agree to an assessment of FICA tax.

The TRAC is an agreement developed by the restaurant industry and the Service. It does not require the establishment of a tip rate or the reporting of tips at a specified rate. Instead, it requires the employer to conduct a program of education for its employees concerning their tip reporting responsibilities and to establish tip reporting procedures which will encourage full reporting. The employer must also make information available to the District Director upon request, including gross receipts from food or beverage sales subject to tipping, charge receipts showing charged tips, total charged tips, and total tips reported.

The District Director can evaluate an employer (or establishment) for compliance in the second calendar quarter, and subsequent calendar quarters, following the quarter in which the TRAC becomes effective. You have stated that Service personnel often review sales journals and cash and charged receipts, as well as interviewing employees. The Service may also review the records used in preparing Form 8027, Employer's Annual information Return of Tip Income and Allocated Tips, as part of a compliance review.

Six alternative versions of the recently revised TRAC and TRDA agreements were published in I.R.B. 2000-19 (May 8, 2000), with requests for public comments. All contain sections entitled "Examinations and/or inspections of books and records," in which participating employers agree that a tip rate validation inspection or compliance review is not an audit within the meaning of section 7605(b) or a prior audit within the meaning of section 530.

LAW

1. Code section 7605(b)

Section 7602(a) establishes the Service's authority to examine books and records.

> (a) AUTHORITY TO SUMMON, ETC.--For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax . . . or collecting any such liability, the Secretary is authorized–
>
> > (1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;

Section 7605(b) places the following restrictions on examinations of taxpayers:

> No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

This subsection prohibits two types of activity: (1) unnecessary examination or investigation and (2) more than one inspection of a taxpayer's books of account for each taxable year in the absence of a request from the taxpayer or a notification in writing from the Secretary that an additional inspection is necessary.

Section 7605(b) was enacted to protect taxpayers from repetitive investigations as a means of harassment. Courts have generally held that the limitations in section 7605(b) must be liberally construed in the government's favor. U.S. v. Schwartz, 469 F.2d 977, 982 (5th Cir. 1972).

2. Section 530

The Small Business Job Protection Act of 1996 amended section 530 to provide that, for purposes of the prior audit safe harbor of section 530(a)(2)(B), a taxpayer may not rely on an audit commenced after December 31, 1996, unless the audit "included an examination for employment tax purposes of whether the individual involved (or any individual holding a position substantially similar to the position held by the individual involved) should be treated as an employee of the taxpayer." Section 530(e)(2)(A).

ANALYSIS

There are three ways to look at the question concerning section 7605(b): 1) Would a court be likely to find a tip rate validation inspection to be an audit? 2) Is a tip rate validation inspection or compliance review an audit under the terms of TRAC and TRDA? 3) Is a tip rate validation inspection or compliance review an audit for the purpose of requiring the IRS to follow all the internal formal audit procedures?

1. Code section 7605(b)

A. Would a court be likely to find a tip rate validation inspection to be an audit?

In general, when the question is raised whether a tip rate validation inspection or compliance review constitutes an examination, the concern is that taxpayers may attempt to use the provisions of section 7605(b) to prevent an examination for purposes of tax assessment. Would a court be likely to find a tip rate validation inspection or compliance review conducted pursuant to TRAC or TRDA to be an audit?

Only a court applying the law to a particular set of facts can give a definitive answer to this question. However, we have received a well reasoned memorandum from Robert A. Miller of General Litigation (attached), which concludes that a tip validation inspection is not an examination. The memorandum also concludes that, even if a court should find it to be an examination, this should not bar an examination for purposes of assessing FICA tax because the tip rate validation examination was for a different purpose, i.e., the purpose of establishing a tip rate for TRAC or TRDA purposes. Please see this memorandum for a detailed examination of case law dealing with Code section 7605(b).

B. Is a tip rate validation inspection or compliance review an audit for purposes of TRAC, TRDA and section 530?

This memorandum is written primarily to address the question of the significance of the compliance review and tip validation inspection in the context of TRAC and TRDA. The current versions of TRAC and TRDA address the problem of the status of compliance review and tip validation inspection by stating how the parties agree to treat these IRS procedures. All six versions of the agreements contain provisions entitled "Examinations and/or inspections of books and records," under which the taxpayer agrees that a compliance review or tip validation inspection for TRAC or TRDA purposes is not an examination within the meaning of section 7605(b).

These provisions in TRAC and TRDA do not guarantee that participants in TRAC or TRDA will never raise section 7605(b) as a defense. These provisions are intended to estop, i.e., to prevent or preclude, taxpayers from raising these arguments in court. We think that the Service has taken reasonable precautions against taxpayers' successfully putting forth such arguments by including these provisions in TRAC and TRDA.

3. Is a tip rate validation or compliance review an audit for the purpose of requiring the IRS to follow all the internal formal audit procedures?

In response to your questions about whether the Service is required to follow established procedures, there is no legal requirement that Service procedures such as notification of a taxpayer that its return is being examined or opening a case on IDRS be followed. These are purely internal procedures. The Service does not view a compliance check or tip validation inspection for TRAC or TRDA purposes as an examination under standard procedures. Therefore there is no need for these procedures to be followed when verifying compliance with TRAC or TRDA.

2. Section 530

This office advised you in our memorandum dated October 1, 1998, that it is no longer reasonable for a taxpayer to rely, for section 530 safe harbor purposes, on an audit that began on or after January 1, 1997, unless it included an examination for employment tax purposes of the classification of the workers or a substantially similar class of workers. The examinations of books and records in a tip validation inspection do not deal with worker classification, and we do not think taxpayers can reasonably make a safe-harbor argument on the basis of the Service's actions pursuant to a TRAC or TRDA.

Nevertheless, TRAC and TRDA contain provisions by which participating employers agree that a compliance review or tip validation inspection for TRAC or TRDA purposes is not a prior audit for purposes of section 530. These provisions are intended to provide assurance that employers participating in these agreements will not be able to parlay them into a section 530 defense.

CONCLUSION

All the current versions of TRAC and TRDA, as set forth in I.R.B. 2000-19, contain provisions in which participating employers agree that a compliance check or tip validation inspection for TRAC and TRDA purposes is not an examination within the meaning of section 7605(b). The purpose of these provisions is to make it difficult for participants to argue successfully that these procedures constitute an audit. If a participant does so argue, the Service will respond that the participant is estopped from advancing the argument, by virtue of the terms of TRAC and TRDA.

For the same reason, TRAC and TRDA also contain provisions by which employers agree that tip validation inspection and compliance check do not constitute a prior audit for section 530 safe harbor purposes. These provisions apply only to taxpayers who participate in TRAC or TRDA. They do not determine the legal significance of the same or similar procedures in other contexts.

Enclosure (1)