

**memorandum**

CC:EL:GL:Br3:CESamuel  
GL-114195-97

date: SEP 16 1997

to: Director, Office of Employment Tax Administration & Compliance  
CP:EX:ST:ET

from: Chief, Branch 3 (General Litigation) CC:EL:GL:Br3

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subject: Inspection of Books and Records for a Tip Validation

By your memorandum dated January 24, 1997, you requested advice from the Associate Chief Counsel (EB/EO) as to whether the inspection of a taxpayer's books and records while performing a Tip Validation constitutes an audit or examination. Your request for advice was forwarded to our office on or about July 25, 1997.

The facts, briefly stated, are as follows. The Service identifies restaurants that show the greatest discrepancy between charged tips and cash tips, and those showing charged tips in excess of reported tips. The Service works with the restaurant to arrive at a correct tip rate using such things and gross receipts, records, and information from employee interviews. In some cases, because the employer does not know what books and records to look at, the Service will look at the employer's books and records to determine the tip rate. In other cases, ~~the Service may need to examine books and records to verify the figures used by the employer to arrive at the tip rate.~~ Ordinarily, the income tax return of the employer would not have been filed yet. In none of the situations will an audit adjustment ever be proposed for any period pertaining to one for which the examiner has inspected the employer's books and records.

You<sup>o</sup> have advised that a district counsel office in Florida has advised their district to "open up the Form 941" for the period of the tip validation although it would result in the return "being closed no change." You have asked: (1) is this the correct return to open; (2) if after the six-month tip determination period when the district goes back to the establishment to evaluate whether the workers are reporting at or above the determined rate, would this be a reopening; (3) if so, is this a reopening of Form 941 return or the income tax return?

I.R.C. § 7605 (b) provides as follows:

No taxpayer shall be subjected to unnecessary examination or investigation, 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.

In addition, Section 5.01 of Rev. Proc. 94-68, 1994-2 C.B. 803, provides that cases closed after examination will not be reopened to make adjustments unfavorable to the taxpayer unless there is evidence of fraud, malfeasance, collusion, or the like, there has been a clearly defined substantial error with regard to preexisting Service policy, or, under the circumstances, failure to reopen the case would be a serious administrative omission. The term "examination" is not defined in the Internal Revenue Code. However, this revenue procedure contains a list (not all inclusive) that describes certain contacts with the taxpayer that do not constitute an examination, inspection, or reopening of an examination.

Your request for advice does not indicate whether you want to know if the case reopening procedures covered by Rev. Proc. 94-68 apply, or whether the provisions of I.R.C. § 7605(b) apply. If your request for advice concerns the case reopening procedures, we suggest that you contact the Associate Chief Counsel (EB/EO) again with a more specific request. This advice only pertains to the provisions of section 7605(b) as they relate to the Tip Validation procedures that you have outlined.

Section 7605(b) imposes restrictions on two activities: (1) unnecessary examination or investigations, and (2) more than one inspection of a taxpayer's books of account for a taxable year. Courts have been reluctant to find a subsequent examination unnecessary absent arbitrariness or an intent to harass. See, United States v. Powell, 379 U.S. 48 (1964); Demasters v. Arend, 313 F.2d 79 (9th Cir. 1963). The Service can conduct additional examinations or investigations of the same taxpayer for the same year as long as there exists a legitimate purpose for the examination and the Service does not harass the taxpayer. Therefore, if a taxpayer's Form 941 return is "opened up" for examination during a Tip Validation, a subsequent examination of the same taxpayer's income tax return would not violate section 7605(b). On the other hand, we believe that the Service could not conduct a subsequent examination of the same taxpayer's Form 941 return for the same period, if the return was examined during the Tip Validation.

When a taxpayer's books and records are inspected in connection with a Tip Validation, clearly there has been an inspection of the taxpayer's books and records, and the second prohibition of section 7605(b) is implicated. However, it has been held that a subsequent inspection of a taxpayer's books of account (for the same tax year) to determine the correct liability for one class of tax, following a prior inspection involving liability for another class class of tax does not require the Service to give notice under section 7605(b). See, United States v. Kendrick, 518 F.2d 842 (7th Cir. 1975). Therefore, if a taxpayer's books and records are inspected in connection with the examination of the Form 941 return, as opposed to merely verifying the tip rate, the Service could not conduct a subsequent inspection of the taxpayer's books and records for the same period and for the same purpose without giving the taxpayer notice as required by section 7605(b). Conversely, if a taxpayer's books and records are inspected in connection with an examination of the Form 941 return, the Service could conduct a subsequent inspection of the same taxpayer's books and records for purposes of an income tax examination. Also, it is our position that an inspection of a taxpayer's books of account for purposes of determining a tax liability (either income or employment tax) following a prior inspection for purposes of verifying a tip rate should be accorded the same treatment under the rationale of Kendrick.

In conclusion, as long as the inspection of the taxpayer's books and records is solely for the purpose of verifying or establishing a tip rate the provisions of section 7605(b) do not apply. ~~If, however, the taxpayer's books and records are inspected in connection with the examination of the Form 941 return, you should follow the advice that we have given in this memorandum. Should you have further questions regarding whether or not to open a return for examination, what returns should be opened for examination, or the how the case reopening procedures covered by Rev. Proc 94-68 apply to such examinations, please request the assistance of the Associate Chief Counsel (EB/EO).~~

If we can be of further assistance, or if you have any questions, please call me or Charles Samuel at 622-3630.

  
LAWRENCE H. SCHATTNER

cc: Associate Chief Counsel (EB/EO)  
Attention: Paul Feinberg