Internal Revenue Service

memorandum

WTA-N-101214-98
CC:EBEO:Br2RSWilson

date:

to: Director, Office of Employment Tax
Administration and Compliance OETAC

from: Office of Associate Chief Counsel
(Employee Benefits and Exempt Organizations) CC:EBEO

subject: Tip Validation Inspection

This is in response to your memorandum requesting technical information regarding inspections of a taxpayer's books and records for purposes of a "tip validation." We apologize for the delay in responding to your request.

You ask whether the tip validation inspection described in your memorandum constitutes an examination for purposes of (1) the safe haven under section 530 of the Revenue Act of 1978 and (2) the reopening procedures. The question about section 530 falls within our jurisdiction, and this memorandum responds to that issue. We asked the Office of Assistant Chief Counsel (Field Service), Procedural Branch, CC:DOM:FS:PROC, to respond directly to you on the issue of the reopening procedures. We understand that you received a response on that issue from General Litigation, CC:EL:GL, on September 16, 1997.

ISSUE

Whether a tip validation inspection constitutes an examination for purposes of the prior audit safe haven under section 530 of the Revenue Act of 1978.

CONCLUSION

[redacted]

Because of the changes made in section 530 by the Small Business Job Protection Act of 1996, it is no longer reasonable for a taxpayer to rely on a prior audit that began on or after January 1, 1997, unless it included an examination for employment

tax purposes of the status of the class of workers at issue or of a substantially similar class of workers.

We do not express a view regarding whether a tip validation inspection is an audit for any other purpose.

FACTS

We understand from your January 1997 memorandum that the Service performs a tip validation inspection to determine whether a restaurant's workers are properly reporting all their tip income. In a tip validation inspection, neither the worker's nor the restaurant's tax return is opened for audit or examination.

You state that the tip validation begins with the District's identifying those restaurants showing (1) the greatest discrepancy between reported charged tips and cash tips and (2) charge tips in excess of reported tips.[1] The District works with the restaurant to arrive at a correct tip rate for the various restaurant occupations. The restaurant uses historical data such as gross receipts records and information from employee interviews to arrive at this rate. If a restaurant furnishes a tip rate that the examiner determines is low, the examiner may verify figures used to arrive at the rate by conducting a sample test of the restaurant's records.

Your memorandum indicates that sometimes the restaurant does not know what books and records to look at or is not sure what is required and asks the District to help determine the tip rate. In that case, the examiner looks through sales records if the rate is to be based on a percentage of sales. The examiner also looks at payroll records for hours worked if the rate is to be based on dollars per hour. When securing a Tip Rate Determination Agreement, the Service uses a six-month period to determine the rate. The six-month period is generally two quarters of the current year. Ordinarily, the income tax return has not yet been filed.

You state that none of these tip validation situations results in the proposal of an audit adjustment for income or payroll taxes for any period for which the examiner has inspected the books and records. This is because of the way adjustments under section 3121(q) of the Code operate, as you explained in your March 1998 memorandum.

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[1] These criteria suggest that an adjustment under Code section 3121(q) will likely be made.

DISCUSSION

The applicable law is explained in the attached May 19, 1994, memorandum to the Assistant Commissioner (Examination) regarding whether certain compliance checks constituted prior audits for purposes of section 530. That memorandum explains that for most purposes, a mere check for compliance that does not seek to make a determination of some general tax liability generally would not rise to the level of an audit. It cautions, however, that for purposes of section 530, a court might construe prior Service activities in the light most favorable to the taxpayer and grant the taxpayer relief under section 530 unless there has been an actual employment tax determination with an assessment for misclassification of workers. We would update the advice in our 1994 memorandum only with respect to two points.

First, the Small Business Job Protection Act of 1996 amended section 530 by adding a new subsection (e) effective for periods after December 31, 1996. Before the amendment, it was reasonable for a taxpayer to rely on any prior audit, unless the audit resulted in an assessment attributable to the taxpayer's employment tax treatment of similarly situated individuals. The former rule is still effective for examinations that began before January 1, 1997. The amendment modified the former rule. For examinations that began on or after January 1, 1997, the prior audit safe haven is limited to audits that included an examination for employment tax purposes of the status of the class of workers at issue or of a substantially similar class of workers. Thus, it is no longer reasonable for a taxpayer to rely on a prior audit that began on or after January 1, 1997, unless it included an examination for employment tax purposes of the status of the class of workers at issue or of a substantially similar class of workers.

Second, since the 1994 memo was written, training materials explaining the operation of section 530 have been prepared. See "Independent Contractor or Employee?" Training 3320-102 (Rev. 10-96) TPDS 84238I. The materials take into account the recent amendments to section 530. The training materials state:

> A business will be able to claim that it was subject to a prior audit if the IRS previously inspected the business's books and records. Mere inquiries or correspondence from a Service Center will not constitute an audit.
>
> If, for example, a correspondence contact was made to verify a discrepancy disclosed by an information matching program, such as Information Returns Processing, self-employment tax, and similar Service Center programs, such contacts do not constitute a prior audit. They are referred to as adjustments.

However, if correspondence contacts entailed the examination or inspection of the business's records to determine the accuracy of deductions claimed on a return, such contacts do constitute an audit for purposes of section 530.

Training 3320-102, at page 1-20.

[redacted]

If there are questions, you may call Rebecca Wilson of this office at (202) 622-6040.

JERRY E. HOLMES
Chief, Branch 2

Attachment:
May 19, 1994, memorandum from Assistant Chief Counsel, Employee Benefits and Exempt Organizations CC:EBEO