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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR Area Counsel (Small Business/Self-Employed:)

FROM: Associate Chief Counsel (Income Tax and Accounting)
CC:ITA

SUBJECT: Tip Rate Review

This Chief Counsel Advice responds to your memorandum dated April 25, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

ISSUES

Whether the Service can reconstruct tip income of casino floor personnel from information either a) developed by the Service currently to determined the tip income of casino food and beverage employees, or b) determined during previous casino rate reviews for such personnel?

Whether the burden of proof will shift under section 7491(b) if the Service reconstructs a casino floor personnel's tip income solely from information either a) developed by the Service currently to determined the tip income of casino food and beverage employees, or b) determined during previous casino rate reviews for such personnel?

CONCLUSIONS

1. The Service may reconstruct tip income for various types of casino employees as long as its method is reasonable in light of all the surrounding facts and circumstances.

2. The use of statistical data from the casinos tip rate review to redetermine tip income for various types of casino employees will not shift the burden of proof under section 7491(b) because the Service's analysis is not based solely on the use of statistical information from unrelated taxpayers.

FACTS

An Examination Compliance Group is participating in the National Tip Strategy as it relates to casinos in a certain geographic area. Aside from its primary goal of increasing compliance levels in tip reporting, an additional goal in working this strategy is to enter into voluntary Tip Rate Determination Agreements with both the employer and the employees of all of the casinos. The Examination Group is currently beginning the compliance phase of the strategy by reviewing the most recently filed Forms 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, for the casinos' food and beverage operations, in order to develop general tipping rates at the corporate casino level. Eventually, these rates will be applied to the hours that tipped food and beverage employees worked in order to determine an employee's correct tip income. The income tax liability on any underreported tip income will eventually be assessed to the employees, and the related section 3121(q) FICA taxes will be assessed to the casinos once the individual income tax assessments are made.

Initially the food and beverage operations of some of the casinos are being reviewed. It is anticipated that after all food and beverage operations have been reviewed at those casinos, the Service will move on to casino floor personnel, i.e. slot attendants, casino floor waitresses and service bartenders. The program will finish by reviewing the remaining tipped employees such as valet parking attendants and hotel bell persons. Eventually all tipped employees working in all of the casinos in that geographic area will be reviewed by the Tip Rate Program.

Usually, the method used to recompute food and beverage employees' tip income is based on what is called the “McQuatters formula”: (1) a charged tip ratio determined using charged tips as a percentage of total charged food and beverage sales; (2) a cash tip ratio determined by reducing the charged tip ratio by a two percent cash differential for cash sales (which are determined by taking total food and beverage sales less a percentage of total sales for “stiffs” (no tip) less charged food and beverage sales); and (3) then applying these ratios to determine total tips. The total tips for a restaurant are then divided by the food and beverage employees’ annual hours to get an hourly tip rate.[1] To put it another way, the McQuatters formula is applied by obtaining from the restaurant the total sales each individual employee had made and reducing those sales for “stiffs”, to arrive at sales subject to tips. The tip rate is then determined by the average tips as shown on charge sales, reduced by approximately 1 to 2 percent (on the assumption that cash tips are generally lower than charged tips), with the resulting percent applied to the food and beverage sales subject to tips.

[1] See McQuatters v. Commissioner, T.C. Memo. 1973-240.

Historically, the method used to determine the tip income of other casino employees (non-restaurant employees) working on a casino's floor was based on surveillance done by IRS Special Agents. This method consisted of observations of various types of employees by teams of Special Agents for 30-minute periods. The agents would go to casino locations randomly selected by a Service statistician and observe the tips given to an employee in that area. The Special Agents were instructed to make certain conservative assumptions; for example, if they could not clearly see a bill, to assume it was a dollar, and if they could not see a coin, to assume it was a quarter. On the basis of these observations, Service statisticians developed a series of figures representing the average tip income of employees in the slot machine and gaming areas.

At present, it appears that Special Agents will not be made available, as they were in the past, to conduct the surveillance required to determine the tip rates of casino floor employees. No determination has been made by the Tip Rate Program Manager for this geographic area on how the tip rates of casino floor personnel will be computed.

LAW AND ANALYSIS

Issue 1

The main issue is the range of application -- horizontally across job classifications and vertically across tax years -- of Service-developed data on tip income in the reconstruction of tip income for casino floor personnel. There is no issue that tips are includible in gross income. Tips are compensation for services rendered and as such are includible in gross income under section 61. Schroeder v. Commissioner, 40 T.C. 30, 33 (1963); Meneguzzo v. Commissioner, 43 T.C. 824, 831 (1965); Catalano v. Commissioner, 81 T.C. 8, 13 (1983), aff'd sub nom. without published opinion Knoll v. Commissioner, 735 F.2d 1370 (9th Cir. 1984); Bruno v. Commissioner, T.C. Memo. 1985-168; Cohen v. Commissioner, T.C. Memo. 1990-650.

Every employee who receives tips must report them to her employer on a monthly basis. Section 6053(a). Certain employers have to report those tips and allocated tips to the Service. Section 6053(c); Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips. Allocated tips generally equal eight percent (8%) of gross receipts, less actual tips reported by the employee. Section 6053(c)(3). Furthermore, all taxpayers are required to maintain records sufficient to determine their correct tax liability. Section 6601; Meneguzzo, 43 T.C. at 831; Way v. Commissioner, T.C. Memo. 1990-590.

If a taxpayer fails to keep the required records, or the records do not clearly reflect income, the Commissioner can, under section 446(b), compute income using any

method that in his opinion does clearly reflect income. Sutherland v. Commissioner, 32 T.C. 862 (1959); Schroeder, 40 T.C. at 33; Way, T.C. Memo. 1990-650. Where a reconstruction of a taxpayer's income is necessary, the Commissioner has great latitude in the method used to make the reconstruction. Id. The method adopted, however, must produce a result that is reasonable and substantially correct. Mendelson v. Commissioner, 305 F. 2d 519, 523 (7th Cir. 1962); Bruno, T.C. Memo. 1990-650.

Although the reconstruction of income need not be exact, it must "be reasonable in light of all the attendant facts and circumstances." Schroeder, 40 T.C. at 33. The Commissioner's method of calculating income is presumptively correct, and will be affirmed so long as it is rationally based. Denison v. Commissioner, 689 F.2d 771, 773 (8th Cir. 1982) (per curiam), citing Cracchiola v. Commissioner, 643 F.2d 1383, 1385 (9th Cir. 1981). Generally, the Courts have held that for a restaurant's employees, the reconstructed amount of tip income can be a flat percentage of food and beverage sales. See Mendelson, 305 F.2d at 521-23; McQuatters, T.C. Memo. 1973-240; Way, T.C. Memo. 1990-590 (involving Las Vegas casino personnel).

With respect to using tip rates developed from a review of a casino's restaurants to determine the tip rates of floor waitresses (who generally serve beverages exclusively), we recognize the different nature of the services provided by casino food and beverage employees and casino floor personnel. While the information developed by the Service to determine the tip income of food and beverage employees may not necessarily produce a result that will reflect the income of floor waitresses with 100% accuracy, we believe that imputing information from waitresses in one area of a casino to waitresses in another may produce a result that is reasonable and substantially correct. In the absence of proper records maintained by a taxpayer, courts have been tolerant of the Service using "blended" information to reconstruct tip income, suggesting that imputed information from one area to another casino area may be acceptable.

A formula based upon personal observations, conversations with casino employees, and a general knowledge of the industry has been approved by the Tax Court. Williams v. Commissioner, T.C. Memo 1985-476. The principal issue in the case was whether the formula developed by the Service and used to determine understatements of tip income was reasonable. While the Court held that the Service's formula itself was reasonable, it found that the formula did not take into consideration the special situations that existed for each waitress. Because of these variations, the court adjusted the formula by taking these "special situations" into consideration.

Reconstruction of income through the use of toke records from other dealers in the same game and casino was an acceptable method of computing income for a

dealer where it is clear that the dealer did not maintain adequate records. Kammeyer v. Commissioner, T.C. Memo. 1991-261, 61 T.C.M. (CCH) 2851.

> Reconstruction of income through the use of toke records of other dealers in the same game and casino is an allowed method to compute income where it is clear that petitioner did not maintain accurate records. . . . In Hannifin v. Commissioner, T.C. Memo. 1980-482, we held that respondent's use of diaries maintained by employees was reasonable. The Ninth Circuit, to which this case would be appealable, has affirmed our decision approving the use of a twenty-one dealer's diary to establish the rate for fellow twenty-one dealers. Keogh v. Commissioner, 713 F.2d 496 (9th Cir. 1983), affg. a Memorandum Opinion of this Court.

61 T.C.M. (CCH) at 2853.

As for statistical surveys being used to determine tip income for casino personnel, such surveys are appropriate methods of reconstructing income. Catalano, 81 T.C. 8 (Las Vegas dealers); Ross v. Commissioner, T.C. Memo. 1989-682 (Atlantic City cocktail server); Bruno, T.C. Memo. 1985-168 (Atlantic City cocktail waitresses).

> Reconstruction of income through statistical sampling is an allowed method to compute income where it is clear that petitioner did not maintain accurate records. Thus, in Ross v. Commissioner, supra, we upheld deficiencies based upon a sampling program almost identical to that utilized in this case. Ross also concerned reconstruction of tips of cocktail waitresses in Atlantic City casinos, but the year 1981. We held in Ross, as we held in Bruno v. Commissioner, supra, that respondent's method of reconstructing tip income was reasonable under the circumstances. Respondent's method of computing income in the 1984-1985 Atlantic City Tip Project was reasonable.

Cohen, T.C. Memo. 1990-650, 60 T.C.M. (CCH) 1509, 1510 (Atlantic City beverage server).

Even if the statistical data is from other years, it may still produce a result that is reasonable and substantially correct. The Tax Court has previously allowed the Service to use data from other tax years to recompute tip income. Farkas v. Commissioner, T.C. Memo. 1986-420. The Tax Court held that in the absence of more current figures, the use of the figures from previous years is justified and

obviously produces the most correct result possible under the circumstances, especially where the record contains no evidence tending to indicate a change in the tip rate over time. Similarly, the Tax Court allowed the use of a tip per drink ratio, based on Atlantic City surveillance conducted in 1980 and 1981, to calculate and reconstruct tip income for a taxpayer's 1978 tax year. Bruno, T.C. Memo. 1985-168. Surveillance conducted between September 1, 1984 and August 31, 1985, was accepted by the Tax Court in order to determine tip rates which were applied to hours worked by a taxpayer during 1983 and 1984. Cohen, T.C. Memo. 1990-650.

Accordingly, our position is that if a casino employee fails to keep the required records or the records maintained do not clearly reflect income, the Service has great latitude in adopting a method for reconstructing income. The reconstruction need only be reasonable in light of all the surrounding facts and circumstances.

We believe that if the Service is unable to conduct surveillance, as it has done in prior years, an argument may be made that it is reasonable for the Service to:

> Use the current tip rates developed for casino food and beverage employees, and apply that information to waitresses, bartenders and other tipped employees that serve customers on the casino floor; or
>
> Use statistical tip rate information from 1996 surveillance, to compute the 1999 tip rates for casino floor personnel.

Based on anecdotal evidence, and premised on the Service's ability to secure an outside expert in this area of casino operations, we believe that it may be possible to determine an increased tip rate for casino floor waitresses over the rate which is determined for casino restaurant waitresses. However, we believe that the Service's preference for reconstructing the tip income for casino floor employees would be to use 1996 surveillance data to compute 1999 tip rates for all the tipped employees working on a casino's floor.

The Program Manager is currently working with a Service statistician to review the old casino data to determine if it is in a form which can still be used, and what, if any, additional work needs to be done with the data.

Issue 2

Generally, the notice of determination issued by the Service is entitled to a presumption of correctness, and the taxpayer bears the burden of proving those determinations are in error. Tax Court Rule 142(a); Welch v. Helvering, 290 U.S.

111, 115 (1933).[2] There are, however, exceptions to this rule. For example, section 7491 shifts the burden to the Service where, in a court proceeding, the taxpayer presents credible evidence and satisfies several conditions. Section 7491(a). More relevant here, under section 7491(b), the burden of proof shifts to the Service where the Service has used only statistical information from unrelated taxpayers to reconstruct an item of the individual taxpayer's income. For this provision to apply, the taxpayer must be an individual and the statistical information must have been the sole information used in the reconstruction, i.e., the statistical information was not merely a component of a greater reconstruction effort.

The phrase "statistical information on unrelated taxpayers" used in section 7491(b) is not defined by the statute or regulations. However, it is the Service's position that section 7491(b) applies only where the statistical information is from sources such as the Bureau of Labor Statistics (BLS), Consumer Price Index (CPI), or similar compilations, and not from the data collected from surveying other employees with similar duties from the same business. Support for this position is found in the legislative history of section 7491, which states that:

> in any instance in which the Secretary uses statistical information from unrelated taxpayers solely to reconstruct an individual taxpayer's income (such as average income for taxpayers in the area in which the taxpayer lives), the burden of proof is on the Secretary with respect to the item of income that was reconstructed by the Secretary.

S. Rep. No. 105-174, at ** (1998). The phrase "average income for taxpayers in the area in which the taxpayer lives" appears to be a reference to the Bureau of Labor statistical listing titled "Average annual expenditures and characteristics, Consumer Expenditure Survey". That listing contains data with regard to expenditures, income, and consumer unit for several metropolitan areas within four regions. See http://stats.bls.gov and attached websites. The BLS listing and other similar collections are designed to provide information with respect to the personal living expenses of an individual in a particular geographic area without consideration of specific occupation, employer, or other similar characteristics which may influence the calculation of items of income. Id. Such data does not necessarily come from persons in the geographic area who share specific characteristics or relationships with the party for whom the information is being applied. Information from BLS and other similar items is intentionally very general for application to a wide variety of scenarios. Within the Service, BLS is used as a source of yearly cost of living information. BLS values are modified using specific expense items, e.g., actual

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[2]In the case of unreported income, the Service's presumption of correctness arises only after the Service links the taxpayer to an income producing activity. See Weimerskirch v. Commissioner, 596 F.2d 358 (9th Cir. 1979).

alimony paid, medical and dental expenses (before limits), and home mortgage interest. See generally I.R.M. §§ 4.2.4.3.3.1(5) and 4.2.4.3.4.5.

The Consumer Price Index, also a BLS statistic, is applied by taking the limited information the Service has been able to obtain and adjusting those values to current amounts in order to reflect the change in prices over time. This method takes little specific information with regard to the taxpayer into consideration.

Comments made during and following hearings on what was to become the I.R.S. Restructuring and Reform Act of 1998, Pub. L. 105-206, 112 Stat. 685, imply that Section 7491(b) was created to assuage Congressional concerns that taxpayers were having to prove their innocence against deficiencies supported only by overly general statistical information. The Tax Court has held in numerous cases that reliance by the Service on BLS statistics to reconstruct taxpayer income is reasonable, and is not arbitrary,[3] where there is an absence of leads as to the source and amount of the taxpayer's income. See Cupp v. Commissioner, 65 T.C. 68 (1975), aff'd. without published opinion 559 F.2d 1207 (3d Cir. 1977); Giddio v. Commissioner, 54 T.C. 1530, 1533 (1970); Bennett v. Commissioner, T.C. Memo. 1998-96. Certainly, the more directly applicable the statistics being used are to the taxpayer's actual characteristics, the less troublesome the use of the information will appear.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Issue 1

In the absence of books and records, the Service is given great latitude with respect to reconstruction of tip income. [redacted]

[3]If the taxpayer were able to demonstrate that the Service's determination was arbitrary and excessive or without rational foundation, then the presumption of correctness would no longer apply and the burden of production would shift to the Service. Pittman v. Commissioner, 100 F.3d 1308, 1317 (7th Cir. 1996), affg. T.C. Memo. 1995-243.

[redacted]

Issue 2

With regard to the scenario addressed in this assistance request, where agents are used to watch certain employees to gather information or, at the very least, several employees with specific job duties are interviewed in each of the relevant areas, the tip reporting program information being gathered is much more specific to the individual.[4] Reviews are done on the casino's grounds with respect to various employees performing specific operations, e.g., food and beverage employees, casino floor employees, and remaining tipped employees. Eventually the program will review all tipped employees in all of the casinos in a certain geographic area. Such information can be applied in a significantly more specific fashion than the information from BLS or CPI, taking into consideration all the individual characteristics accounted for by the survey. [redacted]

Additionally, under section 7491(b), the burden shifts where the statistics are from unrelated taxpayers. With BLS and CPI statistics, as stated above, the statistics may have been generated from other persons in the geographic area who share very few characteristics with the taxpayer, let alone anything which could be termed a relationship for purposes of section 7491(b). Here, however, the statistics are collected on the grounds of the casino at which the taxpayer is employed from other employees of that casino who have similar job duties as the taxpayer. While no official definition of "related" for this context was in the statute nor has been addressed in the regulations, certainly a strong argument can be made that the statistics used in this scenario are from related taxpayers. [redacted]

[4]There appears to be some concern that the information will not be gathered in a manner similar to previous attempts. Once the specific manner of acquiring information is determined, further review may be required.

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call 202 622-7900 if you have any further questions.

Sincerely,
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