



Employer ADVISOR

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ALL ABOUT AUDITS

AUTUMN IS HERE, bringing its share of tricks and treats. An audit notice may feel like a trick, but the process does not have to be a nightmare. This article demystifies the process by explaining why Workforce Services audits employers, what an auditor may review, and how to prepare.

Should I Fear an Audit?

Receiving an audit notice can cause understandable anxiety. But employers who maintain accurate financial records and make worker classification decisions in good faith are better prepared for the process. Workforce Services conducts audits as a routine way to check compliance with unemployment insurance (UI) laws.

1. The Purpose Behind Audits

Audits help ensure fairness across the business community. DWS uses them to verify that:

- **Tax contributions are accurate:** Employers report wages correctly and pay the contributions they owe to the state unemployment trust fund.
- **Businesses compete on a level playing field:** Employers who follow the rules aren't disadvantaged by competitors who underreport wages or misclassify employees as independent contractors.
- **Workers are protected:** Workers who qualify for UI coverage receive the protections available under state law.

2. Benefits of an Audit for Compliant Employers

An audit isn't necessarily a negative experience. It can also help an employer:

- **Tax credit qualification (FUTA Credit):** Proper compliance with state unemployment tax requirements, including timely payment, allows

eligible employers to maintain a tax credit of up to 90% under the Federal Unemployment Tax Act (FUTA).

- **Safe haven status:** Completing an audit and receiving an official determination that specific workers are independent contractors may provide an employer with "safe haven" protection from retroactive liability for those workers.
- **Correct errors:** An audit may uncover accounting errors or overpayments, allowing an employer to correct the issue or receive an applicable tax adjustment.

3. When Does an Audit Become a Problem?

An audit can become a serious issue if it uncovers violations, such as:

- **Deliberate worker misclassification:** Intentionally treating employees as 1099 independent contractors to avoid UI contributions.
- **Payrolling violations:** Paying workers off the books, using unauthorized common paymaster setups or underreporting corporate officer compensation.
- **Refusing records access:** Failing to maintain required payroll records for at least three calendar years or refusing to provide records to the DWS auditor.

Pro Tip: Employers who maintain organized records, issue accurate Forms 1099 and W-2, and consult tax or legal counsel when worker classifications are unclear can make the audit process more straightforward.

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WHAT CAN I EXPECT?

A DWS employer audit reviews a business's books and records to check compliance with UI laws.

1. Scope of Required Records and Examination

An auditor may inspect and copy any records needed to evaluate claimant eligibility and employer liability, including records from at least the preceding three calendar years. Documents examined may include:

- Payroll records, timecards, and wage lists
- Disbursement records, general ledgers, and check registers
- Federal and state tax returns and IRS filings
- Contracts, Forms 1099 and W-2, and operating or LLC agreements
- Personnel records, meeting minutes, and regulatory or business licenses

2. Key Issues Evaluated

- **Independent contractor status:** Evaluating whether workers are free from the employer's control or direction and are customarily engaged in an independently established business.
- **Reclassification of corporate payments:** Reviewing dividends, officer loans, property distributions, or expense reimbursements paid to corporate officers or LLC managers to determine whether they should be reported as wages.
- **Payrolling and common paymaster:** Verifying that the entity with the right to hire, fire, control, and direct workers is reporting their wages, and identifying prohibited payrolling or unauthorized common paymaster setups.
- **Exempt employment:** Verifying qualification for specific statutory exemptions, such as sole proprietor family exemptions, casual labor, or licensed commission sales.

3. Audit Outcomes and Next Steps

- **Adjustments and assessments:** If errors or unreported wages are found, DWS issues an audit report and recalculates the contributions owed, which may include back taxes, interest, and penalties.

- **Misclassification reporting:** If 10 or more workers are found to be misclassified, the employer has 90 days from the final audit report to address the misclassification by paying or making payment arrangements. Otherwise, the information may be shared with the U.S. Department of Labor.
- **Appeal rights:** Employers have the right to appeal audit determinations or rate reclassifications. Deadlines vary by the type of notice and how it is delivered, so employers should follow the instructions on the notice.

WHY AM I BEING AUDITED?

1. Audit Selection Criteria

Employers are generally selected for an audit in one of three ways:

- **Random sampling:** DWS audits a percentage of employers selected at random each year to check compliance across different industries.
- **Targeted or risk-based audits:** Accounts may be selected for closer review when reported information raises questions, such as unusual fluctuations in reported wages, frequent 1099 filings for core business work, high use of independent contractors, or discrepancies between federal and state tax filings.
- **Claimants or inquiries:** An audit may be triggered immediately if a former worker files a claim for unemployment benefits and DWS finds that the worker's wages were not reported, or if DWS receives a worker misclassification complaint.

Re-audits: A business that completes an audit without major issues typically is not audited again for several years. Businesses with significant misclassifications or underreported wages may be monitored and audited more frequently.

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