

EMPLOYMENT TAX AUDIT PROCESS

INTRODUCTION

The California Unemployment Insurance Code ([CUIC](#)) and the [Government Code](#) authorize the Employment Development Department (EDD) to conduct payroll tax audits of businesses operating in California. The payroll tax audit verifies compliance with the CUIC, ensures workers are properly classified, payments made to employees are properly reported, and protects workers' rights to receive benefits.

PERIOD COVERED BY THE AUDIT

Generally, the EDD employment tax audits cover a three-year statutory period, comprising the 12 most recently completed calendar quarters. An audit begins with the examination of records for a test year which is generally the most recent completed calendar year. However, the examination may be expanded to include the records for the entire period covered by the audit and in some situations may extend beyond the three-year statutory period.

ENTRANCE INTERVIEW

Before reviewing your records, the auditor will conduct an entrance interview with you or your designated representative to explain the purpose of the audit and the audit process, gather general information about the operation and organization of your business and accounting records, and answer any of your questions.

RECORDKEEPING

Payroll systems can be as basic as a manual system with only a check register and individual earnings records or as complex as a computerized double entry system on an accrual basis. Provisions of the CUIC require employers to keep payroll records providing a true and accurate account of all workers (employed, laid off, on a leave of absence, or an independent contractor) and all payments made. The type of system you use should meet the needs of your business and EDD requirements. Requirements are further explained in the EDD's *California Employer's Guide*, [DE 44](#).

SCOPE OF THE AUDIT

The auditor will review your books and records to:

- Verify the business ownership and type of entity (sole proprietorship, partnership, corporation, etc.).

- Verify that all individuals paid for services have been properly classified as either employees or independent contractors in accordance with the provisions of the CUIC and the common law test as applied by the State Supreme Court.
- Discuss any questionable payments made for personal services and the nature of the working relationship(s) with you and the worker(s). Based on the facts obtained from the records, input from you, and discussion(s) with the worker(s), the auditor will determine whether the worker(s) are employees or independent contractors.

In addition, if your account has been selected for a complete audit, the following tests will be performed:

- Verification that your acknowledged gross wages and taxable wages have been properly reported.
- Verification that you have correctly withheld and reported personal income tax for wages paid to your employees.

PROVIDING BUSINESS RECORDS FOR THE AUDIT

To expedite the audit process, please ensure that the records listed on page 2 are made available to the auditor. The examination of records may be limited to the records listed in item 1, but there may be a need to examine the records in item 2 as well. Therefore, please have all the listed records available for the period indicated at the top of page 2. In addition, if worker classification issues are encountered, the auditor may need to examine other documents, such as invoices, billings, corporate minutes, or other written agreements.

EDD – INTERNAL REVENUE SERVICE (IRS) EXCHANGE AGREEMENT

The EDD employment tax audit information is made available to the [IRS](#) under an exchange agreement, and the IRS may use the information in the administration of its tax program.

PLEASE MAKE AVAILABLE RECORDS FOR THE PERIOD OF _____

NOTE: An audit begins with the examination of records for a test year. The test year is generally the most recent completed calendar year. If differences are found in the test year, then the examination may be expanded to include the records for the entire period covered by the audit.

1. MINIMUM REQUIRED RECORDS

Sections 1085 and 1092 of the CUIC require all employing units to make business records available to the EDD during normal business hours. These records include:

- Check registers, check stubs, canceled checks, and bank statements
- General ledger and general journal
- Annual financial statements (income and expense statements, balance sheet, etc.)
- Cash payments records (pay out slips and vouchers)
- Ownership verification
 - City business license
 - California Department of Tax and Fee Administration number
 - Any license required to operate your business, such as a liquor license, California Contractor's State License, etc.
 - Written agreements (such as Partnership Agreement or Articles of Incorporation)
- Federal/State income tax returns
- [Form 1099](#) series, federal information returns, and worksheets

2. ADDITIONAL RECORDS REQUIRED FOR VERIFICATION OF ACKNOWLEDGED PAYROLL

- Payroll records such as payroll journal, individual earnings records, payroll summaries, etc.
- Federal employment tax reports:
 - *Wage and Tax Statement*, [Form W-2](#)
 - *Employee's Withholding Allowance Certificate*, [Form W-4](#)
 - *Employer's Quarterly Federal Tax Return*, [Form 941](#)
 - *Employer's Annual Federal Unemployment Tax Return*, [Form 940](#)

- State employment tax reports:
 - *Quarterly Contribution Return and Report of Wages*, DE 9
 - *Quarterly Contribution Return and Report of Wages (Continuation)*, DE 9C
 - *Quarterly Contribution and Wage Adjustment Form*, [DE 9ADJ](#)
 - *Tax and Wage Adjustment Form*, [DE 678](#)
 - *Employee's Withholding Allowance Certificate*, [DE 4](#)

DISCUSSION OF AUDIT FINDINGS

As part of the audit, the auditor will arrange for an exit interview, either in person or by phone, to review the audit findings, identify any other information that should be considered, and attempt to resolve disputed issues, if any. If you do not reach an agreement with the auditor, you may request a pre-assessment conference with the supervisor of the auditor.

The audit will result in one of the following outcomes:

- A no-change audit, where no differences are found.
- An overpayment, where a credit or refund will be issued.
- An underpayment, where the differences will be assessed.
- Both an underpayment and overpayment.

APPEAL

If an assessment is issued, you will receive information about your appeal rights (*Employer's Bill of Rights*, [DE 195](#)). You may petition for reassessment with an independent third party, the [California Unemployment Insurance Appeals Board](#), for a hearing before an Administrative Law Judge.

TAXPAYER ADVOCATE OFFICE

If you are unable to resolve an employment tax problem with the assigned EDD representative, supervisor, and office manager, you may contact the Taxpayer Advocate Office at 1-916-654-8957 or toll-free at 1-866-594-4177.

The EDD is an equal opportunity employer/program. Auxiliary aids and services are available upon request to individuals with disabilities. Requests for services, aids, and/or alternate formats need to be made by calling 1-888-745-3886 (voice) or TTY 1-800-547-9565.

This information sheet is provided as a public service and is intended to provide nontechnical assistance. Every attempt has been made to provide information that is consistent with the appropriate statutes, rules, and administrative and court decisions. Any information that is inconsistent with the law, regulations, and administrative and court decisions is not binding on either the Employment Development Department or the taxpayer. Any information provided is not intended to be legal, accounting, tax, investment, or other professional advice.