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ESD Audits: What They Are, How to Prepare, and Best Practices for Employers

Overview of ESD Audits

The Washington State Employment Security Department (ESD) audits records of employers located in Washington to confirm that wages and hours are accurately reported and to ensure compliance with the state's unemployment insurance laws and rules.

The U.S. Department of Labor (DOL) requires ESD to conduct compliance audits annually, and ESD selects which employers to audit based on whether: (1) the employer has a pattern of inconsistent reporting; (2) the employer is in an industry with a historically high level of noncompliance; (3) the employer transferred ownership or reclassified the business type; (4) any citizen submitted reports of fraud; or (5) the employer is randomly selected by a computer (about 10% of total audits). Notably, being selected for an audit *does not* mean that an employer has violated any laws or rules.

If an employer is selected for an audit, ESD's auditors will contact the employer by phone, email, or letter to notify the employer of the pending audit; identify the records to be inspected; and will set a mutually agreeable date, location, and time to conduct the audit. Additionally, ESD will send the employer an appointment confirmation letter, a pre-audit questionnaire, and a required records checklist to be completed.

During the audit, ESD auditors will perform a wide variety of functions, including look for evidence of unreported employees, casual labor, independent contractors, and other workers who provide personal labor; sample payroll and time records to compare them to wages and hours reported to ESD; and review the type of business activity and whether a new employer is assigned the correct tax rate. ESD auditors typically request records dating back three years, but if an auditor finds questionable business practices, the audit may be expanded. ([RCW 50.24.190](#)). Specifically, ESD auditors typically review: (1) payroll, accounting, and employee time records; (2) business ownership records and licenses; (3) bank records, financial statements, check registers, general ledgers, and invoices; (4) state and federal tax records, including IRS Form 1099s; (5) subcontractor registration numbers, copies of contracts and invoices; and (6) corporate officer opt-in forms. Additionally, ESD auditors examine whether employers have properly reported independent contractors according to the following tests.

ESD's Independent Contractor Tests

One of the most common mistakes that employers make when filing unemployment insurance tax reports each quarter is misclassifying employees as independent contractors. If ESD discovers these mistakes during an audit, the employer must pay back taxes for all misclassified workers, plus penalties and interest. Accordingly, employers should become familiar with the following tests that ESD uses to determine a worker's status. Put simply, if a worker passes one of the following tests, they are an independent contractor. If not, the worker is an employee and should be included in the employer's quarterly unemployment tax report.

Independent Contractor Test for Most Industries

First, for all workers except those in the electrical and construction industries, service performed by an individual for compensation is employment (and the worker qualifies as an employee) unless the employer can demonstrate:

1. The individual is free from direction and control over the performance of the service; *and*
2. The service is either performed:
 1. Outside of the usual course of business for which the service is performed, *or*
 2. Outside of all the places of business of the enterprise for which the service is performed; *and*
3. The individual is customarily engaged in an independently established trade, occupation, profession, or business of the same nature as that involved in service contract. ([RCW 50.04.140\(1\)](#))

Or, as a separate alternative, service performed by an individual for compensation is employment unless the employer can show:

1. The individual is free from direction and control over the performance of the service; *and*
2. The service is either performed:
 1. Outside of the usual course of business for which the service is performed, *or*
 2. Outside of all places of business of the enterprise for which the service is performed, *or*
 3. The individual has a principal place of business that is eligible for a federal income tax business; *and*
3. The individual:
 1. Is customarily engaged in an independently established trade, occupation, profession, or business of the same nature as that involved in the service contract, *or*
 2. Has a principal place of business that is eligible for a federal income tax business deduction; *and*
4. On the effective date of the contract of service, the individual is responsible for filing a schedule of expenses with the Internal Revenue Service (IRS); *and*
5. On the effective date of the contract or within a reasonable period after the effective date of the contract, the individual has established:
 1. An active account with the Department of Revenue, *and*
 2. An active account with any other state agencies as required by the particular case, *and*
 3. A Unified Business Identifier (UBI) number; *and*
6. On the effective date of contract of service, the individual is maintaining a separate set of books or records that reflect all items of income and expenses of the business that the individual is conducting. ([RCW 50.04.140\(2\)](#))

Independent Contractor Test for Electrical and Construction Industries

Second, for workers in the electrical and construction industries, ESD uses a slightly different test that incorporates a contractor registration requirement. Specifically, for electrical and construction workers, ESD uses the six-factor alternative test above and, in addition, requires the individual to have a valid contractor registration on the effective date of the contract under RCW 18.27 or an electrical contractor license under RCW 19.28 if the work requires a registration or license. ([RCW 50.04.145](#)). This means that in addition to meeting the six-factor test above, workers in the electrical or construction industries must be validly registered as contractors to qualify as independent contractors under the law.

Following the Conclusion of an ESD Audit

At the end of an audit, the ESD auditor will send a post-audit letter to the employer explaining the audit's findings. If the audit results in the employer owing taxes, penalties, or interest, ESD will send a Notice and Order of Assessment (NOA) to the employer detailing any taxes due, penalty, and/or interest liability.

If an employer disagrees with the NOA, it can file an appeal by writing a letter on employer letterhead requesting an appeal and mailing it to ESD-Tax Appeals, or to an Office of Administrative Hearings (OAH) location. ESD must receive the letter within 30 days of the date on the NOA. Appeal hearings are usually conducted over the phone by the OAH, and decisions are typically issued approximately two weeks after the hearing concludes. If the ESD's findings are reversed, ESD will adjust the employer's account according to the OAH's findings. If the ESD's findings are affirmed, and the employer disagrees, the employer can file a Petition for Review with the Commissioner's Review Office (CRO). The Petition for Review must be in writing, must be sent to the Employment Security Department's Records Center, P.O. Box 9555, MS-6000, Olympia, WA, 98507-9555, and must be postmarked and sent within 30 days of the date OAH mailed its decision to the employer. If an employer disagrees with the CRO's decision, it may file a written appeal to the Washington State Superior Court within 30 days.

Best Practices and Pitfalls to Avoid

1. Understand the legal standards for independent contractor liability (listed above);
2. Have independent contractors sign independent contract agreements that, among other things, explicitly disclaim control and direction over the worker and do not bind contractors to company policies;
3. Ensure that independent contractors have their own business entity/license, perform independent contractor work for other entities, and do not list company as their employer on any resume, website, or social media platform such as LinkedIn;
4. Retain for at least three years records establishing independent contractor relationship such as the contract, invoices (with description of services that are not part of the business of the company, etc.); and
5. If contacted by the ESD for an audit, employers should respond in a timely manner to all letters, phone calls, questions, and requests for information; have an employer representative at the audit who is familiar with the operations of the employer and payroll records; provide an on-site work area that is private or outside of customer view to conduct the audit; and ensure the requested records are well organized and can be easily identified by the auditor.

Finally, employers should consult with trusted legal counsel if they have any questions or concerns regarding the ESD audit process or whether workers qualify as independent contractors or employees.

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