

# How to prepare for an audit: A guide for small businesses

## *Narrative video script*

Department of Revenue  
Department of Labor & Industries  
Employment Security Department

### **Introduction**

If you're a small-business owner, the prospect of an audit can be intimidating. This video is for you. You'll learn what to expect if you are audited by the Washington State Department of Revenue, Labor & Industries, or Employment Security.

We'll cover basic information about what the three agencies look for in their audits.

If you want more detailed information, check out the three agency tabs below. You'll find links to many topics we cover in the video.

If you're a large-business owner, or an accountant or bookkeeper, you'll see a tab called "For accountants" that has information relevant to you.

This video is divided into chapters to make it easier to use. The first chapter covers basic audit information that is general to all three agencies. Then, you can select the chapter for the agency you're interested in.

### **Chapter 1    Audit basics**

This chapter gives you a snapshot of audits in general. We'll talk about:

- How and why a business is selected for an audit,
- How to properly keep records, and
- What you can expect if you're contacted for an audit.

## **How businesses are selected**

If you've been selected for an audit, it doesn't necessarily mean you've done something wrong. Businesses are often selected for audits at random, and across geographic areas and industries. A business also can be selected because of:

- A pattern of inconsistent reporting,
- Improper use of exemptions,
- A history of discrepancies, or
- A tip received about a non-compliant employer.

We understand that an audit can be stressful. Please don't hesitate to ask questions if something isn't clear.

## **When contacted for an audit**

When you're contacted for an audit, here are some general guidelines to follow:

Respond quickly to all letters, phone calls, and requests for information.

You get to decide if you want a third party, such as your accountant or bookkeeper, involved in the audit.

You'll also need to provide an on-site work area for the auditor.

Because the auditor will review confidential information, you should find a spot that's out of customer view.

The auditor will ask for your records. If you can't get them right away, let the auditor know when you will be able to provide them.

If you keep electronic records, you may be asked to share them in that format.

## **If you owe money or want to appeal**

If you end up owing money after the audit and you can't pay all of it – or if you want to appeal – the agency that audited you can help. Each agency has links to information about appeals in the tabs below this video.

## **Audit information can be shared**

Finally, be aware that the results of an agency's audits are sometimes shared with other city, state, and federal agencies.

Now let's look at specific audit information for each agency.

## **Chapter 2 Department of Revenue**

This chapter covers audits by the Department of Revenue. We'll go over:

- Why the Department audits,
- Your responsibilities as a business,
- What you can expect and what the auditor will ask of you during the audit, and
- Appealing the audit, or getting help if you can't pay.

If we cover a topic that raises questions, or you want more details, check the "Revenue" tab below and follow the links to the information you're looking for.

### **Why the Department of Revenue audits**

The Department of Revenue audits to ensure that state taxes, like sales tax and tax on business receipts, are reported and paid correctly. These taxes fund essential government services like basic education and public safety.

### **Your responsibilities**

As a Washington business, you are required to register with the Department of Revenue. If you don't, you may face penalties.

If you have an unregistered business and come forward voluntarily, these penalties may be reduced or waived.

In addition to registering your business, you are required to:

- Know your tax reporting obligations,
- Keep accurate and complete business records,
- File returns and pay taxes on time,
- File accurate tax returns,
- Substantiate claims for refund, and
- Notify the Department and pay taxes promptly when you close your business.

Part of knowing your tax reporting obligations is knowing which taxes you must pay.

First, you need to know which business and occupation tax classification your activity falls under, and report it properly on the excise tax return.

The most common reporting classifications include:

- Retailing
- Wholesaling
- Manufacturing, and
- Service and other.

If your business activities change over time, verify the proper business and occupation classification for the new activity. Reporting these changes can make a big difference in how much you pay in taxes.

### **Retail sales tax**

You also must know whether or not you need to collect sales tax.

You must report and maintain records for all retail sales tax you collect.

Sales tax rates vary by city and county, and each jurisdiction has its own local sales tax code for reporting on your excise tax return. This ensures that each jurisdiction is getting its fair share of tax revenue.

Collect sales tax at the rate for the location where your customer receives the goods.

Be sure to document the correct location code for each of your retail sales.

If you need help determining the correct sales tax rate or code, go to the “Revenue” tab below and look for the section called “Find a tax rate or location code.”

You also must document all deductions, credits, and sales that are not subject to retail sales tax, including:

- Wholesale sales,
- Sales to non-residents,
- Sales to Indians, and
- U.S. Government sales.

While these examples are not subject to retail sales tax, they are subject to business and occupation tax.

### **Use tax**

You also should know about use tax, and when you might owe it. You owe use tax on items your business uses, but which were not subject to sales tax.

Your use tax rate is the same as your sales tax rate. The amount you need to report is generally the cost of the item, including shipping charges.

Here are some examples of items on which a business might owe use tax:

- Purchases from out-of-state vendors, like computers, art, clothing, and promotional items;
- Items used in your business that are not resold, like office supplies, equipment, and tools; and
- Purchases from your suppliers that are used to conduct your business, like a drill purchased by a contractor.

If you make purchases with a reseller permit on items who which you should have paid sales tax, you owe use tax.

It's critical that you understand the rules around using a reseller permit. If you use it improperly, you may be subject to penalties, even if you didn't intend to misuse it.

### **Special taxes**

There are also some special taxes that apply to different businesses. Please take the time to find out if any of these apply to your business.

### **Exemptions, deductions, and credits**

Finally, you need to know which exemptions, deductions, and credits you qualify for.

What your business reports as income to the IRS should match what you report to the state. If the amounts are different, you will need to explain the difference during your audit.

### **Inform multiple agencies if your business status changes**

You may need to inform multiple agencies when your business status changes.

Changes can include: a new type of activity; hiring new employees; change in business structure, such as sole proprietorship to corporation; or an office relocation.

### **If you need assistance**

In general, if you are uncertain about a tax issue, you should call the Department of Revenue. If you need a binding tax ruling, you can write in to request one.

For more information on Department of Revenue audits, you're welcome to attend one of our new-business tax workshops. And you're welcome to attend, even if you're not a new business.

Check the "Revenue" tab below for more information.

### **If you are selected for an audit**

If you are selected for an audit by the Department of Revenue, you will be contacted by phone or letter. The auditor will tell you which business records you need to make available for review.

You and the auditor will set a date, location, and time for the audit that works for both of you.

You also will receive a confirmation letter, along with a form you complete if you want a third-party or non-employee, such as your accountant or bookkeeper, to be involved in the audit.

Before the audit begins, the auditor will spend some time with you discussing your business activities and recordkeeping practices.

### **When the audit begins**

When the audit begins, the auditor may review a variety of records to:

- Verify gross income, including reconciling to your federal income tax returns,
- Review expenses for unexplained credits,
- Verify tax classifications,
- Review documents supporting deductions you have taken,
- Review sales tax accrual accounts,
- Review use tax liability or accrual accounts,
- Review capital asset invoices and depreciation schedules, and
- Review purchase invoices to verify sales tax or use tax has been paid.

You must keep your business records for the current year, plus the past four years.

The one exception to this rule is for retail sales tax. You should keep all past records for retail sales.

### **After the audit**

After the audit, the auditor will discuss the preliminary findings with you, and explain any interest or penalties.

The auditor also will explain the appeals process and offer a supervisor’s conference if you disagree with the audit findings.

Before you receive the final audit findings, the audit will be reviewed within the Department.

If there are no audit findings, you will receive a letter confirming that there are no tax adjustments.

If there is an adjustment, and you owe taxes, you will receive an invoice with a due date. You also will receive a document explaining the audit findings by schedule.

### **If you have a hard time paying**

If you have a hard time paying the assessment, contact the audit manager whose name appears on the invoice.

It is important that you contact the Department before the due date shown on the invoice. If you don’t, you may owe penalties and additional interest.

### **To appeal**

To appeal an audit decision, please contact the appeals division of Department of Revenue.

This concludes the “Revenue” section of this video. Again, you can find links to more detailed information, including how to contact the Department, in the “Revenue” tab below.

## **Chapter 3 Department of Labor & Industries**

In this chapter, we will go over audits by Labor & Industries. We’ll cover:

- Why the Department audits,
- Your responsibilities—including reporting and recordkeeping,
- What you can expect during the audit, and
- What to do if you can’t pay or want to appeal.

Throughout this chapter, if we cover a topic that raises questions for you or you need more details, check the “Labor & Industries” tab below for links to the information you need.

## **Why the Department audits**

The Department of Labor & Industries audits to ensure that each employer is paying its share of workers' compensation premiums so injured workers can be fairly compensated and rates are held down for all employers.

Your premium is based on the number of hours your employees work.

An exception to this is the drywall industry. For more information about reporting in that industry, look in the "Labor and Industries" tab below.

## **Your responsibilities**

L&I requires you to report all employees, including short-term employees.

You also must report any casual laborers, certain volunteers, and many independent contractors.

## **Independent contractors**

Workers' compensation must be reported and paid for independent contractors unless they meet the following six requirements:

First, the contractor is free to complete the job without any direction from you.

Second, at least one of the following must apply:

- The contractor is not in your line of work,
- The contractor performs his or her work outside all of your places of business, or
- The contractor is responsible for the costs of the principal place of business where he or she performs the services.

Third, at least one of the following must apply:

- The contractor is normally engaged in an independently-established business, or
- The contractor has a principal place of business that is eligible for an IRS business deduction.

The fourth requirement is that the contractor is responsible for filing a schedule of business expenses with the IRS.

Fifth, the contractor is registered with the Department of Revenue and all other appropriate state agencies to pay all required taxes to the State of Washington.

And finally, the contractor maintains a separate set of business records that reflect all business income and expenses.

The contractor must meet all six requirements to be exempted from workers' compensation. Otherwise, the contractor must be covered.

Additionally, to be exempted from workers' compensation in the construction industry, the contractor must have a valid contractor registration.

If you have more questions about independent contractors' requirements, go to the "Labor and Industries" tab and click "A Guide to Hiring Independent Contractors in Washington State."

### **Rules for reporting**

The rules for reporting employees or other covered workers vary slightly, depending on whether the individual is paid by salary or commission.

For salaried employees:

- You can report actual hours worked, or
- You can report 160 hours per month, which is standard for full-time employment.

For commissioned employees who work outside the employer's business premises:

- You can report actual hours worked, or
- You can report eight hours per day for part-time, or 160 hours per month for full-time employees.

If you choose to report your salaried or outside commissioned workers at 160 hours per month, you must report all salaried and outside commissioned workers by that same method.

For commissioned employees who work inside the employer's business premises, and for hourly employees and piecework employees, you must always report actual hours worked, including overtime.

For audits by L&I, you must keep the following records for 13 quarters, which is three years and three months:

- Employee names and Social Security numbers,
- Dates of employment,
- Basis of pay—meaning hourly, salary, commission, or piece work,
- Location of work,
- Job title and type of work performed,
- Daily record of hours worked,
- Original time cards or sheets,
- Gross pay for each pay period, and
- Payroll deductions for each pay period.

For more information about recordkeeping and reporting requirements, go to the “Labor and Industries” tab below and click “L&I Employer Audit Self Service Library.”

### **What to expect if you are audited**

Now, let’s go over what you can expect if you are audited by Labor & Industries.

The auditor will contact you by phone or letter to explain why you’re being audited and to let you know which records you will need to produce for review.

You and the auditor will set a date, location, and time for the audit that works for both of you.

The auditor will send you an appointment-confirmation letter, pre-audit questionnaire, and required-records checklist.

On the pre-audit questionnaire, you will provide general information about the structure of your business, ownership, operations, workers, and contract labor. Please complete this questionnaire before the audit.

The required-records checklist details the specific records you need to make available for review.

Before beginning the review of your records, the auditor will explain the audit process to you and ask some questions.

### **During the audit**

The auditor will look for unreported employees, casual labor, and independent contractors who provide essentially personal labor.

He or she will sample payroll and time records to compare them to the hours you have reported to L&I.

The auditor also will determine if the workers' hours were reported in the correct risk classification.

He or she will ask for additional information or clarification if needed. If you have questions at any time during the audit, you shouldn't hesitate to ask.

### **After the audit**

After the audit, the auditor will:

- Give you a preliminary look at the audit results, if possible,
- Explain any interest and penalties,
- Provide you with future reporting instructions,
- Ask you for any additional documents that are needed,
- Make necessary changes based on additional records you provide, and
- If you request it, the auditor will explain the reconsideration and appeal process.

You will receive a report that explains the audit findings. It will show: no findings, a credit, or a debt owed.

### **What to do if you can't pay or want to appeal**

If you have a hard time paying the assessment, contact the L&I revenue agent who is assigned to you after the audit.

The agent will work with you to make payment arrangements.

It's important to contact the Department before the due date shown on the *Notice and Order of Assessment*.

If you don't, you will miss the reconsideration and appeal period.

To appeal the results of an audit, submit a written reconsideration request to the L&I revenue agent.

You also can appeal the audit results to the Board of Industrial Insurance Appeals. The board is an independent panel that reviews and rules on worker's compensation appeals.

This appeal is a formal hearing that may or may not change the results of your audit.

This concludes the “Labor and Industries” section of this video. Again, you can find links to more detailed information, including how to contact the Department, in the “Labor and Industries” tab below.

## **Chapter 4    Employment Security Department**

This chapter covers audits by the Employment Security Department. We’ll go over:

- Why the Department audits,
- Your reporting responsibilities, including information on independent contractors,
- How businesses are selected,
- What you can expect during the audit, and
- Appealing the audit, or getting help if you can’t pay.

Throughout this chapter, if we cover a topic that raises questions for you or you need more details, click the “Employment Security” tab below for links to the information you need.

### **Why Employment Security audits**

Employment Security audits employers to provide a level playing field for all businesses and to protect the rights and benefits of workers.

### **Reporting responsibilities**

Most employers pay quarterly taxes on their workers.

Those that do not pay quarterly taxes can include 501(c)(3) non-profit organizations, governmental agencies, and Indian tribes. These employers directly reimburse the state for benefits paid to their laid-off workers.

Taxable employers must pay taxes on all of their workers, unless those workers are independent contractors or are exempt for some other reason.

### **Independent contractors**

Employment Security determines whether your worker is an independent contractor using tests established in state law.

You can see the tests and other independent contractor information in the “Employment Security” tab.

The tests ask several questions related to such issues as the individual's type of business, place of business, tax-filing status, and the degree of control you have over the individual's work.

### **Electrical and construction workers**

There is a slightly different test and a contractor registration requirement for electrical and construction workers.

First, the contractor is free to complete the job without any direction from you.

Second, at least one of the following must apply:

- The contractor is not in your line of work,
- The contractor performs his or her work outside all of your places of business, or
- The contractor is responsible for the costs of the principal place of business where he or she performs the services.

Third, at least one of the following must apply:

- The contractor is normally engaged in an independently-established business, or
- The contractor has a principal place of business that is eligible for an IRS business deduction.

The fourth requirement is that the contractor is responsible for filing a schedule of business expenses with the IRS.

Fifth, the contractor is registered with the Department of Revenue and all other appropriate state agencies to pay all required taxes to the State of Washington.

And finally, the contractor maintains a separate set of business records that reflect all business income and expenses.

Due to the complexity of the independent contractor issue, we find that employers sometimes misinterpret the rules and end up having to pay taxes and penalties on workers they thought were independent contractors.

We suggest contacting your Employment Security district tax office if you have any questions about whether a worker is an independent contractor. When you call, a tax specialist will speak with you. You will not be routed through an automated system.

## **Exempt from unemployment-insurance taxes**

Besides independent contractors, there are some other individuals whom businesses do not have to cover for unemployment insurance. The most typical are:

- Sole proprietors, their spouses, and unmarried children who are 18 or younger;
- Students working on small agricultural farms for employers with less than a \$20,000 payroll; and
- Domestic service providers whose employer has a payroll of less than \$1,000 every quarter.

Check with the agency for a complete list.

## **How businesses are selected**

When the Employment Security Department selects an employer for an audit, it can be based on:

- A focus on specific industries based on historical audit data,
- Tips about possible tax evasion or other tax-reporting problems,
- Random selection, or
- Cross-matched data with other agencies.

## **Voluntary audits**

As an employer, you also can request a voluntary audit to get help meeting your reporting requirements.

If you owe unpaid taxes found during a voluntary audit, you will have to pay the taxes and interest, but you won't be charged penalties.

## **What to expect if you are audited**

Now, let's go over what you can expect if you are audited by Employment Security.

The auditor will contact you by phone to tell you why you're being audited, explain the audit process, and set up a meeting time agreeable to both of you.

You will receive a brochure that explains the audit process, and a confirmation letter that lists the records you will need to make available.

You'll need to provide an on-site work area for the auditor.

Because the auditor will review confidential information, you should find a spot that's out of customer view.

You are also welcome to request that the audit be conducted at your local district tax office.

Once the audit begins, the auditor will review your basic financial statements and payroll documents to make sure that the correct amount of taxes has been paid.

Under the “Employment Security” tab, see “Who and what you must report” for a list of records you need to maintain.

You must keep your business tax records for at least five years.

After the audit, the auditor will discuss the findings and next steps with you.

### **If you owe money**

If you owe money and think you will have a hard time paying, you may be able to make payment arrangements.

Contact your Employment Security district tax office for more information. You’ll find contact information for district tax offices under the “Employment Security” tab.

To avoid some penalties, be sure you contact the tax office before your payment is due.

### **You can appeal**

If you don’t agree with an Employment Security audit decision, you may request a review from an administrative law judge.

If you don’t agree with the judge’s decision, you can appeal to:

- The Commissioner’s Review Office,
- Your county’s Superior Court,
- The Washington State Court of Appeals, and ultimately to the
- Washington State Supreme Court

You will receive information about filing an appeal when you receive your audit results.

This concludes the “Employment Security” section of this video. Again, you can find links to more detailed information, including how to contact the Department, in the “Employment Security” tab below.

## Conclusion

We've covered a lot of information in this video. You can find contact information for all three agencies under the agency tabs below.

You can reach us on the web, by phone, or by mail.

And last, thank you for paying your fair share of Washington taxes. You can help us keep the playing field level by reporting businesses that are engaging in fraud—and not paying their fair share. Visit *suspectfraud.com* for more information.

On behalf of the Departments of Revenue and Labor and Industries, and the Employment Security Department, we hope you have found this video helpful. And we hope we've made your audit a little easier. Thanks for watching.

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